Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

HOECHST CELANESE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of California

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the nexus and fair apportionment requirements of the Due Process and Commerce Clauses of the United States Constitution preclude a State from imposing an income/franchise tax upon the pension reversion investment income of a non-domiciliary corporation.

2. Whether this Court should clarify the "operational" versus "investment" analysis set forth in *Allied-Signal, Inc. v. Director, N.J. Div. of Tax*, 504 U.S. 768 (1992).

3. Whether the California Supreme Court erred in interpreting and applying this Court's decision in *Allied-Signal, Inc. v. Director, N.J. Div. of Tax*, 504 U.S. 768 (1992).

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.6 STATEMENT

Petitioner Hoechst Celanese Corporation changed its name to CNA Holdings, Inc., effective August 17, 1999. CNA Holdings, Inc. is a wholly-owned subsidiary of Celanese Americas Corporation, which is a wholly-owned subsidiary of Celanese A.G.. Celanese A.G. is a publicly traded corporation. During the year in issue, 1985, Hoechst Celanese Corporation (formerly Celanese Corporation) was a publicly traded corporation, with no parent corporation, and no publicly held company owned 10% or more of Celanese's stock.

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PETITION FOR A WRIT OF CERTIORARI

Hoechst Celanese Corporation respectfully petitions for a writ of certiorari to review the judgment of the Supreme Court of the State of California.

OPINIONS BELOW

The Opinion of the Supreme Court of California (Appendix ("App.") 1a-49a) is officially reported at 25 Cal.4th 508 (2001). The Opinion of the Court of Appeal of the State of California, Third Appellate District, (App. 50a-71a) and modification (App. 72a-74a) were officially reported at 76 Cal.App.4th 914 (1999) and 77 Cal.App.4th 512B (2000), respectively. The judgment and statement of decision of the Superior Court of California, County of Sacramento (App. 75a-97a) are not officially reported.

JURISDICTION

The judgment of the Supreme Court of California was entered on May 14, 2001. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS AND OTHER AUTHORITY INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides, in relevant part:

"The Congress shall have Power . . . [t]o regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const. amend. XIV, § 1, provides, in relevant part: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes, regulations, and other legal authority are set forth in the Appendix at pages 98a-99a.

STATEMENT

This case raises significant issues with respect to state taxation of a multistate corporation's income arising out of investment functions. This case involves a California corporation/franchise tax refund claim filed by Petitioner Hoechst Celanese Corporation ("Celanese") with Respondent Franchise Tax Board ("FTB") for the income year ended December 31, 1985 ("year in issue"), based upon its claim that California cannot tax a $388.8 million investment gain which resulted from Celanese terminating its overfunded pension plan and reverting the excess funds.

This case raises a question of extraordinary importance to state taxpayers and state taxing authorities throughout the nation: whether a state may tax pension reversion investment income of a non-domiciliary corporation which arose from the corporation's termination and reversion of an overfunded pension plan. Less than

ten years ago, this Court concluded that a capital transaction that serves an investment function cannot be taxed by a non-domiciliary state. *Allied-Signal, Inc. v. Director, N.J. Div. of Tax*, 504 U.S. 768 (1992). This Court's opinion in *Allied-Signal* did not fully articulate what is meant by an "operational function," the consequence of which is that many states, including California in the decision below, have so broadly interpreted that test so as to destroy the concept of a distinction between an "investment" and an "operational" asset. This case squarely presents the issue of when an asset is an "operational" asset under *Allied-Signal*.

1. The Facts

Celanese is organized under the laws of Delaware, with its principal place of business in New Jersey and a commercial domicile of New York during the year in issue. Celanese, together with its subsidiaries and affiliates, manufactures and sells a diversified line of chemicals, fibers and specialty products, and has done so since 1947.

a. History of the Pension Plan

Celanese created and maintained a qualified defined benefit plan for its employees known as the Celanese Retirement Income Plan ("Plan"), which covered both current and retired employees. (Chronological Index for the Original File of the Superior Court ("CI"), p. 193.) Celanese also created a tax exempt trust known as the Celanese Retirement Income Plan Trust ("Trust") to receive and invest Celanese's contributions to the Plan. (*Id.*) The Plan went through many forms over a number of

years, and dates back to other plans which date back to July 1, 1947. (*Id.*)

The Plan conformed to ERISA[1], and was a qualified plan under the Internal Revenue Code. (*Id.*) The Trust was an exempt trust under the Internal Revenue Code. (*Id.*) Celanese periodically made contributions to the Trust in such amounts as determined by an independent actuary to satisfy federally mandated minimum funding standards and to provide sufficient funds for the benefits described and promised under the Plan. (*Id.*) All such contributions and all gains therefrom were held in trust by the Trustee, Chase Manhattan Bank. (*Id.*) Subject to ERISA limitations, the contributions by Celanese to the Trust completely discharged Celanese's financial obligations under the Plan. (*Id.*) Celanese was obligated to make contributions to the Plan each year. Even in 1984, when Celanese knew the overfunded Plan was going to be terminated and the excess funds reverted, Celanese was still obligated to contribute $21 million to the Plan. (Reporter's Transcript ("RT") 98:1-9.)

Celanese never showed the assets of any of the various versions of the Plan or Trust on its balance sheet, and never showed the earnings from any of the versions of the Trust as part of its financial results or income. (RT 63:26-28; 64:1-12.)

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[1] "ERISA" is the Employee Retirement Income Security Act, which is set forth at 29 U.S.C. §§ 1001 et seq.

b. The Pension Plan Termination and Reversion

By the early 1980s, it became clear to Celanese that because of the tremendous growth in the Trust assets caused by investment gains by the Trust's outside investment managers and brokers, the Trust had become overfunded. (CI, p. 285.) By December 31, 1982, the trust funds increased by $341 million – from $276 million as of December 31, 1978, to $617 million as of December 31, 1982. (Joint Exhibit 4.) Net distributions (payments to retirees) and contributions accounted for 27% of this growth, with the remaining 73% resulting from investment gains as the fund managers outperformed the "market." (*Id.*) The investment gains continued to grow. By May 31, 1984, the fund was 27% ahead of an index weighted 60% S&P 500 returns and 40% on fixed income returns – up from 24% as of December 31, 1983. (Joint Exhibit 5, p. 2.) From January 1979 through May 31, 1984, investment gains of $310 million and net contributions of $63 million had increased the value of the fund to $626 million. (Joint Exhibit 5, p. 6.) Celanese made the decision to terminate the Plan and Trust, and to revert the excess funds to the company. (Joint Exhibits 4 & 5.) The purpose for obtaining the reversion was to avoid a surplus in the plan from being used in a takeover bid to acquire the corporation's stock. (CI, p. 286.)

It took Celanese over two years to obtain federal approval for the pension reversion. (RT 58:22-27.) It met with representatives of the Pension Benefit Guarantee Corporation, the Internal Revenue Service, the Department of Labor and members of the President's Economic

Advisory Counsel in 1983 to discuss whether or not pension reversions were even possible. (RT 58:3-13.) The ultimate outcome of the meetings was that in May 1984, the Pension Benefit Guarantee Corporation and IRS jointly issued guidelines prescribing rules whereby employers could recapture the surplus assets of pension plans. (RT 58:14-17.) The reversion then had to be approved by both the Internal Revenue Service and the Pension Benefit Guaranty Corporation. (RT 58:18-21.)

In October 1983, as part of the pension reversion process, Celanese filed a request with the Internal Revenue Service for a tax determination with respect to splitting the Plan/Trust effective January 1, 1984. (Joint Exhibit 7.) The Internal Revenue Service subsequently issued the requested determination. (*Id.*)

Effective January 1, 1984, the Plan and the Trust were divided into two plans and two trusts, in order to satisfy Internal Revenue Code and Internal Revenue Service requirements. (CI, pp. 194-195.) The Celanese Retirement Income Plan ("CRIP") covered active employees, and the Celanese Retirement Security Plan ("CRSP") covered retired employees. (CI, p. 194.) Both plans were qualified defined benefit plans under the Internal Revenue Code. (*Id.*) By resolution of Celanese's Board of Directors, the assets of the Trust were allocated between the "CRIP Trust" and the "CRSP Trust" so as to ensure that all benefits accrued were as fully funded immediately after the transfer as they were immediately before the transfer, as required by the Internal Revenue Code. (CI, pp. 194-195.) Both the CRSP Plan and the CRSP Trust were created to be terminated after purchasing annuities for retirees, with surplus assets reverting to Celanese. (*Id.*)

The annuities were paid for on June 1, 1984, at a cost of approximately $110 million. (CI, p. 195.)

After satisfying all CRSP obligations, the CRSP Trust paid Celanese $388.8 million, which represented CRSP Trust assets in excess of liabilities. (*Id.*) Celanese reported the pension reversion gain as taxable income on its 1985 corporation income tax returns for New York (and New York City) and paid tax on that gain to New York (and New York City). (CI, p. 192.)

The pension reversion was a once-in-a-lifetime corporate occurrence. (App. 24a-25a.)

2. The Assessment

Celanese filed its California franchise tax return for the year in issue based on the position that pension reversion investment income was nonbusiness income not taxable by California. Celanese was then audited by FTB for the year in issue, and a deficiency assessment was proposed by FTB. (CI, p. 192.) Years of administrative proceedings followed. Celanese contended throughout these proceedings that the pension reversion investment income was nonbusiness income not taxable by California, and that FTB's taxation of this income was unconstitutional. Ultimately, Celanese paid the contested taxes under protest, and filed a claim for refund with FTB. (*See* CI, pp. 192-193; Joint Exhibit 1.) That refund claim was denied. (CI, p. 279.)

3. The Decisions Below

In 1996, Celanese filed suit for refund in the Superior Court of California. Celanese continued to allege the pension reversion investment income was nonbusiness income not taxable by FTB, and that FTB's taxation of the pension reversion investment income violated the Commerce and Due Process Clauses of the United States Constitution. In 1998, the Superior Court held the pension reversion investment income was business income, and upheld the constitutionality of California's taxation of the pension reversion gain. (App. 97a.) Having concluded the pension plan constituted an "integral part of Celanese's business operations" under the California statutory definition of "business income," the Superior Court then summarily concluded "the qualified pension trust clearly served an operational function of Celanese" under *Allied-Signal*. (App. 96a.)

Celanese appealed the Superior Court decision to the Court of Appeal. The Court of Appeal reversed the Superior Court. (App. 71a.) The Court of Appeal determined the pension reversion investment income was not "business income" under the California statutory definition. (App. 71a.) Having decided the case on other grounds, the Court of Appeal did not reach the constitutionality issues.

The FTB appealed the Court of Appeal decision to the California Supreme Court. The California Supreme Court reversed the Court of Appeal. (App. 45a.) The California Supreme Court held the pension reversion investment income was "business income" under the California statutory definition. Addressing the constitutional

issues in less than three pages of its forty-page majority decision, and devoting only three paragraphs to *Allied-Signal,* the California Supreme Court analyzed *Allied-Signal,* and observed that "[A]lthough the United States Supreme Court has not clearly differentiated operational and investment function, it has stated that an asset serves an operational function if it helps the taxpayer 'make better use . . . of [its] existing business-related resources.' (*Container Corp., supra,* 463 U.S. at p. 178.)" (App. 44a.) The California Supreme Court then concluded that "the pension plan and trust undoubtedly helped Hoechst 'make better use' of an important and existing business-related resource – its employees. (*Container Corp., supra,* 463 U.S. at p. 178.)" (App. 44a.)

A dissenting opinion was filed, which warned "the majority's definition of business income is potentially all-encompassing * * * potentially reach[ing] *all* income from business-owned property, thereby rendering illusory, the category of nonallocable 'nonbusiness' income . . . " (App. 46a.) The dissent also pointed out the California Supreme Court's opinion "encourages conflicting claims by defining as allocable 'business income' (Rev. & Tax. Code, § 25120, subd. (a)) precisely the same type of income that the highest court of a sister state in the only other decision directly on point[2] has defined as

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[2] The "other decision directly on point" which is referred to in the dissent is the recent decision by the North Carolina Supreme Court in *Union Carbide v. Offerman,* 526 S.E.2d 167 (N.C. 2000). There, under nearly identical facts, and interpreting a nearly identical statute to California's "business income" statute, the highest court of North Carolina held a pension reversion was not taxable by North Carolina.

nonallocable 'nonbusiness income' (*id.*, subd. (d); *Union Carbide Corp. v. Offerman* (N.C. 2000) 526 S.E.2d 167)." (App. 46a.)

REASONS FOR GRANTING THIS PETITION

The decision of the California Supreme Court warrants review by this Court for any of three reasons.

First, the California Supreme Court has issued a decision with extremely broad implications for taxpayers doing business across state lines. In substance, that court held anything which helps a taxpayer "make better use" of existing business related resources is taxable in any and all states in which that taxpayer does business. The California Supreme Court reaches this overly generalized test by misreading and misinterpreting this Court's decision in *Allied-Signal*. Rather than looking to *Allied-Signal* for guidance on the meaning of the "operational" versus "investment" dichotomy, the California Supreme Court ignored *Allied-Signal*, and instead reached back nearly ten years before *Allied-Signal* to this Court's decision in *Container Corp.*, where the issue was *not* how an asset was used in a taxpayer's business, but whether the taxpayer was engaged in a unitary business. In other words, the California Supreme Court confused and intertwined the unitary business analysis in *Container Corp.* with the asset (operational versus investment) analysis in *Allied-Signal*. Recall there was no "unitary" issue presented in *Allied-Signal*, based upon a stipulation between the parties to that case. *Allied-Signal, supra*, 504 U.S. at 774. The issue in

Allied-Signal was whether in the *absence* of a unitary relationship, a capital transaction serves an operational rather than investment function. *Id.* at 787. The California Supreme Court mixes apples (unitary under *Container Corp.*) and oranges (examination of the capital transaction under *Allied-Signal*), thus torturing the language of *Allied-Signal* to expand it to allow states to tax literally every "better use" of an asset.

Second, this Court should resolve the conflict existing between courts and state taxing agencies with respect to the interpretation and application of the operational function test under *Allied-Signal.* The California Supreme Court's decision below is only one of many judicial and administrative decisions which have attempted to interpret and apply this Court's *Allied-Signal* operational test. Jurisdictions will continue to inconsistently interpret and apply *Allied-Signal*, seriously undermining constitutional restraints on state taxation, without this Court's resolution of this issue.

Third, the decision below poses a serious threat to constitutional restraints on state taxation by (1) allowing a state to tax the income of a corporation having no minimum connection between the interstate activities and the taxing state, and (2) allowing a state to tax value earned outside its borders, both in violation of the Due Process and Commerce Clauses.

I. THIS COURT SHOULD RESOLVE THE QUESTION OF WHETHER A TAXPAYER MERELY "MAKING BETTER USE" OF A (NON-UNITARY) BUSINESS ASSET SATISFIES *ALLIED-SIGNAL'S* OPERATIONAL STANDARD

A. The Decision Below Raises the Substantial Question of What is Meant by "Operational" under *Allied-Signal*

In *Allied-Signal,* this Court held that in the absence of a unitary relationship, a state may only tax a capital transaction where it serves an operational rather than an investment function. *Allied-Signal, supra,* 504 U.S. at 787. At issue in *Allied-Signal* was the taxability of a gain on the sale of stock of a New Jersey corporation, held by the taxpayer for over two years, and then sold back to the New Jersey corporation for a gain of approximately $211 million. *Allied-Signal* did not involve the issue of whether a state sought to tax extraterritorial values under the unitary business principle.[3] Rather, *Allied-Signal* dealt only with the apportionability of a capital gain realized by the taxpayer on a sale of its stock in the context of a non-unitary relationship. *Id.* at 773-774. This Court held in *Allied-Signal* that "the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases," but "[w]hat is required

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[3] The parties to *Allied-Signal* expressly agreed the taxpayer and corporation whose stock was sold by the taxpayer had no unitary relationship – the parties stipulated that these corporations "were unrelated business enterprises each of whose activities has nothing to do with each other." *Allied-Signal,* 504 U.S. at 774.

instead is that the capital transaction serve an operational rather than an investment function." *Id.* at 786-787.

Allied-Signal's discussion of the limits of the Due Process and Commerce Clauses emphasized that a state may not tax income "earned in the course of activities unrelated to [those carried out in the taxing] State." *Allied-Signal,* at 787 (quoting *Exxon Corp. v. Dep't of Rev. of Wis.,* 447 U.S. 207, 223 (1980)). As the Court pointed out, the existence of a unitary relationship between payee and payor is one justification for appointment, but not the only one. *Allied-Signal,* at 787. Absent such a unitary relationship, the Due Process and Commerce Clauses are satisfied *only* if the capital transaction serves an operational function. *Id.*

Allied-Signal stressed, as this Court had previously held in *ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307 (1982), that "the fact that a transaction was undertaken for a business purpose does not change its character. [Citation omitted] Idaho had argued [in *ASARCO*] that intangible income could be treated as earned in the course of a unitary business if the intangible property which produced the income is 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " *Allied Signal, supra,* 504 U.S. at 788-789 (quoting *ASARCO,* 458 U.S. at 326). In rejecting this argument, this Court observed in *ASARCO*:

> This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its operations, including investment made, in some sense

> can be said to be 'for purposes related to or contributing to the [corporation's] business.' When pressed to its logical limit, this conception of the 'unitary business' limitation becomes no limitation at all.

ASARCO, 458 U.S. at 326 (emphasis added); *see also Allied-Signal*, 504 U.S. at 789.

Quoting this language, this Court in *Allied-Signal* declared that apart from semantics, it saw no distinction between the "purpose" test rejected in *ASARCO* and an "ingrained acquisition-divestiture policy" adopted by the New Jersey Supreme Court in the lower court decision in *Allied-Signal*.

While the California Supreme Court in its decision gives lip-service to the proposition that "the mere fact a transaction has a 'business purpose' is not enough" (App. 44a), the truth of the matter is that the California Supreme Court then goes on to adopt a standard which is indistinguishable from the standard this Court rejected in *ASARCO* and again in *Allied-Signal*. It does this by creating a "make better use" test under this Court's decision in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

Celanese submits the California Supreme Court badly misreads *Container Corp.* as providing guidance on the meaning of the distinction between "operational" and "investment" functions. *Container Corp.* pre-dates *Allied-Signal* by nearly ten years and is a case which involves the unitary business principle. In *Container Corp.*, California sought to tax, by application of the unitary business principle, income the taxpayer received from its wholly

owned and majority owned foreign subsidiaries, each of which was in the same business as the parent. *Container Corp.* at 463 U.S. 171-174. In the course of determining that California's application of the unitary business principle to the taxpayer and its foreign subsidiaries was proper and that its use of the standard three-factor formula to apportion the income of that unitary business was fair, this Court reaffirmed that the constitutional test with respect to the unitary business inquiry focuses on "functional integration, centralization of management, and economies of sale." *Id.* at 179 (citing *F.W. Woolworth Co. v. Tax. & Rev. Dep't of N.M.*, 458 U.S. 354, 364 (1982); *Mobil Oil Corp. v. Commssioner of Taxes of Vt.*, 445 U.S. 425, 438 (1980)), and 184.

The language from *Container Corp.*, which the California Supreme Court cites as its "operational" definition, is taken badly out of context, because the quoted language is in the context of the unitary business determination. One of the taxpayer's contentions in *Container Corp.* was that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. *Container Corp.*, 463 U.S. at 178. In responding to *this* argument by the taxpayer, this Court in *Container Corp.* stated:

> When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to *make better use* – either through economies of scale or through operational integration or sharing of expertise – *of the parent's existing business-related resources.* Finally, appellant urges us to adopt a bright-line rule requiring as a prerequisite to a finding that a

> mercantile or manufacturing enterprise is unitary that it be characterized by 'a substantial flow of goods.'

Id. (emphasis added.)

This language from *Container Corp.*, the only language looked to by the California Supreme Court on the "operational" issue, is clearly directed to the issue of unity, and specifically to the taxpayer's claim in that case that a state administrative presumption involving unity was invalid. This language from *Container Corp.* has *nothing* whatsoever to do with the "operational" issue presented in *Allied-Signal,* which is the issue presented by Celanese's pension reversion gain. In sum, the California Supreme Court took language out of context from *Container Corp.*, used that language to create a new "operational" test which is blatantly inconsistent with *Allied-Signal,* and then ruled against Celanese after applying the flawed test. The California Supreme Court's purported "better use" test suffers from all the same flaws pointed out in *ASARCO,* and again in *Allied-Signal,* because pressed to its logical limit, it "becomes no limitation at all." *ASARCO,* 458 U.S. at 326. This is precisely the point made by the dissent to the Celanese California Supreme Court opinion, which warned "[t]he first problem is that the majority's definition of business income under the functional test potentially reaches *all* income from business-owned property, thereby rendering illusory, or nearly illusory, the category of nonallocable income . . . " (App. 46a.)

Clearly, the California Supreme Court's broad reading of the California "business income" statute is in conflict with *Allied-Signal.* California imposes a franchise tax

measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. The tax depends upon the corporation's net income attributable to in-state sources. Cal. Rev. & Tax. Code § 25101; *A.M. Castle & Co. v. Franchise Tax Bd.*, 36 Cal.App.4th 1794, 1798 (1995). Under the California Bank and Corporation Tax Law, all income of a multistate corporate taxpayer such as Celanese is either "business income" or "nonbusiness income."

Business income is defined in California Revenue and Taxation Code section 25120, subdivision (a) as follows: " 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Nonbusiness income is defined in California Revenue and Taxation Code section 25120, subdivision (d), as "all income other than business income." Business income is apportioned by formula.[4] Nonbusiness income is allocated to a specific jurisdiction based upon a series of rules, depending upon the type of income. Cal. Rev. & Tax. Code § 25123 *et seq.*

The decision below by the California Supreme Court declares that income is apportionable "business income" under the statute "if the taxpayer's acquisition, control

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[4] The mechanics of California's apportionment formula are not in issue in this case.

and use of the property contribute materially to the taxpayer's production of business income." (App. 33a.) The California Supreme Court went on to conclude that Celanese's control and use of the pension plan assets, even though Celanese did not own or hold legal title to those assets, "contributed materially to its production of business income by improving the efficiency and quality of its workforce which, in turn, generated Hoechst's business income." (App. 40a.) Clearly, the California Supreme Court's test of taxability which looks to "material contribution" to the taxpayer's business as a standard for a state's taxation of the income of a multistate business, is inconsistent with *Allied-Signal.* Absent constitutional guidance by this Court, states will continue to make decisions that are not only inconsistent with *Allied-Signal,* but also inconsistent with decisions of sister states. The California Supreme Court's decision is at direct odds with the North Carolina Supreme Court. Under nearly identical facts and nearly the identical statutory language, the California Supreme Court has defined as business income precisely the same income that the North Carolina Supreme Court has defined as nonallocable business income. *See Union Carbide, supra,* 526 S.E.2d 167.

California is traditionally viewed as a "leader" among states in the field of state taxation, and its decisions are frequently cited and followed in other jurisdictions. The California Supreme Court decision in this case is the *only* decision by that court, the highest court of California, to address the *Allied-Signal* apportionable business income issue. In light of the manifest burdens that will be imposed on interstate commerce if the ruling below stands, it is essential for this Court to review this

case and to delineate the meaning of "operational" in *Allied-Signal* in a manner that is more protective of Commerce and Due Process Clause concerns.

B. The Pension Reversion is Not Taxable by FTB Under *Allied-Signal*

The practical ramifications of the California Supreme Court's misapplication of *Allied-Signal* can be seen in the results of that decision. California's sweeping interpretation of its "business income" statute, discussed above, taxes Celanese's pension reversion gain which so clearly cannot be taxed under *Allied-Signal.*

The California Supreme Court concluded the Celanese pension plan and investments served an operational function because Celanese "created and maintained the plan and trust in order to induce its current employees to stay and to attract new employees," and as "such, the pension plan and trust undoubtedly helped Hoechst 'make better use' of an important and existing business-related resource – its employees. (*Container Corp., supra,* 463 U.S. at p. 178.)" (App. 44a-45a.)

As discussed above, "making better use" of an asset is *not* the constitutional standard under *Allied-Signal.* The proper standard is whether the capital transaction served an operational, rather than investment, function. The answer to this question is that clearly the pension plan reversion served an investment function, and is thus not constitutionally taxable by FTB.

The assets of the pension plan consisted of investments of nonworking capital by Celanese. ERISA prohibited Celanese from controlling the operations of the plan or using plan assets in its business operations. The contributions made by Celanese to the pension plan were determined by an independent actuary to satisfy federally mandated minimum funding standards, and to provide sufficient funds for the benefits described and promised under the pension plan. All investments and all gains therefrom were held in trust and managed by a third party. Celanese never showed the assets of the pension plan or the trust on its balance sheet, and never showed the earnings from the pension plan or the trust as part of its financial results or income.

It is important to remember that the investment income in issue in this case is the income resulting from the reversion of *excess* pension funds. In other words, by definition, the pension reversion investment income was of funds *not* needed to maintain the pension plan. By the early 1980s, it became clear to Celanese that because of the tremendous growth in the trust assets caused by unexpected investment gains by the trust's outside investment managers and brokers, the trust had become grossly overfunded. Net distributions (payments to retirees) and contributions accounted for 27% of this growth, with the remaining 73% resulting from investment gains as the fund managers outperformed the "market."

It is undisputed the pension reversion was a rare, once-in-a-corporate lifetime event for Celanese, and certainly was not an event in the normal course of its business. Indeed, recall it took Celanese over two years to

obtain federal approval for the pension reversion, and involved meetings with the Pension Benefit Guarantee Corporation, the Internal Revenue Service, the Department of Labor and members of the President's Economic Advisory Counsel in 1983 to discuss whether or not pension reversions were even possible. In order to effectuate the reversion, Celanese divided the plan and the trust into two plans and two trusts, and assets of the trusts were then allocated between the CRIP Trust and the CRSP Trust so as to ensure that all benefits accrued were as fully funded immediately after the transfer as they were immediately before the transfer. The CRSP Plan and the CRSP Trust were created to be terminated after purchasing annuities for retirees, with surplus assets reverting to Celanese. The annuities were paid at a cost of approximately $110 million, and after satisfying all CRSP obligations, the CRSP Trust paid Celanese $388.8 million, which represented CRSP Trust assets in excess of liabilities needed to meet all pension benefits.

What could be less "operational" than this pension reversion gain which resulted from a once-in-a-corporate lifetime event; which required two years of extensive effort to obtain government approval; and which had nothing whatsoever to do with Celanese's regular trade or business activities – the manufacturing and selling of chemicals and fibers?

The California Supreme Court took the position the gain was operational (and hence, taxable by the FTB) because the plan and trust helped Celanese "make better use" of its employees. (App. 44a.) However, the pension reversion had no effect whatsoever on Celanese's employees – either active or retired. Current and active

employees continued to receive the same benefits under the CRIP Plan. Retired employees continued to receive the same benefits under the annuities purchased by the CRSP Plan, prior to its termination and the reversion. Only *after* all current and retired employees were assured their benefits were the excess funds reverted to Celanese upon the termination of the CRSP Plan and CRSP Trust. The pension reversion investment income which is the subject of this case has nothing to do with "making better use" of Celanese's employees.

The pension reversion gain was the result of investment gains in the pension plan which were above and beyond those funds needed to meet any needs of current and retired employees. It was the contributions to the plan, *not* the excess funds which were reverted, which provided for the retirement needs of current and retired employees. The clearest evidence of this fact is that Celanese was obligated to contribute $21 million to the pension plan in 1984 while working on the pension plan reversion and at a time when Celanese *knew* the plan was overfunded and that the excess funds were going to be reverted. Thus, the excess funds in the pension plan were not linked to Celanese somehow "inducing" current employees to stay or to "attract" new employees, as claimed by the California Supreme Court, because (1) the excess funds in the plan were not used or needed to meet employee pension needs; and (2) current and retired employees continued to receive unchanged benefits even after the termination of the CRSP Plan and the reversion.

Indeed, Celanese's facts present an even *stronger* basis for finding the income cannot be taxed than the facts in *Allied-Signal*. In *Allied-Signal*, the taxpayer

retained ownership and control over its investment in the stock in issue, and could freely use the income generated therefrom in its business operations, and *still* this Court found the income from the sale of this stock was nonapportionable passive investment income. If the taxpayer's income in *Allied-Signal* can be characterized as such, then Celanese's is a *fortiori* case because Celanese had no such control and no such ability to use excess income in its business operations, short of the once-in-a-corporate lifetime reversion.

Whether Celanese is subject to tax by California under these facts raises a substantial question of national significance regarding the meaning of this Court's "operational" test in *Allied-Signal.*

II. THE ISSUE OF HOW THE OPERATIONAL TEST IN *ALLIED-SIGNAL* SHOULD BE INTERPRETED AND APPLIED IS RIPE FOR RESOLUTION BY THIS COURT

Currently, state courts and administrative taxing agencies are at the point in interpreting the operational test that they were 20 years ago in interpreting the unitary test. The California Supreme Court's decision below is one of many judicial and state administrative decisions which have attempted to interpret and apply this Court's operational function test language under *Allied-Signal.* Jurisdictions will continue to inconsistently interpret and apply *Allied-Signal,* seriously undermining constitutional restraints on state taxation, without this Court's immediate resolution of this issue.

Since *Allied-Signal* was decided in 1992, many states have attempted to tax all kinds of "nonunitary" income. The California Supreme Court's decision below is only one example of such an approach. This approach, however, completely overlooks the firmly rooted principles set forth by this Court in the series of cases beginning with *Exxon* and *Woolworth*, continuing through *ASARCO*, and concluding in *Allied-Signal*.

The arguments made by the FTB, and adopted in the decision below, are strikingly similar to the arguments made by the state revenue departments and rejected by this Court in *F.W. Woolworth Co. v. Tax. & Rev. Dep't of N.M.*, 458 U.S. 354 (1982) and *ASARCO, Inc. v. Idaho St. Tax Comm'n*, 458 U.S. 307 (1982), and to the argument made by the New Jersey Division of Taxation and rejected by this Court in *Allied-Signal*. Historically, aggressive states have attempted to tax income if it was connected *in any way* to a taxpayer. For instance, in 1979, the Supreme Court of Colorado held that the gain from a sale by Atlantic Richfield could constitutionally be apportioned to Colorado because the sale had business motives, could have been anticipated by the taxpayer, and the taxpayer had a history of buying and selling companies. *Atlantic Richfield Co. v. Colorado*, 601 P.2d 628, 632 (Colo. 1979). In this same time period, the Supreme Judicial Court of Massachusetts held that W.R. Grace & Co.'s sale of stock was constitutionally apportionable to Massachusetts because the income from the sale of the stock was "derived from business" and the taxpayer had a history of buying and selling companies. *W.R. Grace & Co. v. Commissioner of Rev.*, 393 N.E.2d 330, 334 (Mass. 1979).

It is only when this Court elects to intervene that this "overtaxation" trend by the states is ever restrained. The "business-related" reasoning behind *Atlantic Richfield* and *W.R. Grace*, which relied heavily upon the Idaho Supreme Court decision in *ASARCO*, was ultimately rejected by this Court. In *ASARCO*, this Court held that Idaho's taxation of the gain from a sale of stock by the taxpayer was unconstitutional. *ASARCO, supra*, 458 U.S. 307. Idaho had argued the purpose of the taxpayer's acquisition of the shares of stock should control, and that where there is some integration between the "business use of the intangible asset (the shares of stock) and ASARCO's mining, smelting, and refining business," the stock is part of a unitary business. *Id.* at 326. As discussed above, this Court unequivocally rejected this "business-related" reasoning in *ASARO*. *Id.*

This Court's decision in *ASARCO* was followed by *Allied-Signal* where this Court once again rejected this "business-related" reasoning, and articulated an operational test. *Allied-Signal*, 504 U.S. at 788-789 (quoting *ASARCO*, 458 U.S. at 326).

Today, similar to 20 years ago with respect to the unitary test, many courts and state taxing agencies are interpreting and applying the operational function test language under *Allied-Signal* not only as aggressively as possible, but also inconsistently. The state courts and taxing agencies are attempting to extend the operational function test language under *Allied-Signal* to revive the pre-1982 position of many states that virtually all income is apportionable. This is clearly demonstrated in the decision below by the California Supreme Court.

This Court has not taken a case applying or interpreting the "operational" language since *Allied-Signal* in 1992. At the time of this Court's decision in *Allied-Signal*, it was a concern of the dissent that this Court in its decision "leaves 'operational function' largely undefined." *Allied-Signal*, 504 U.S. at 792. Celanese respectfully submits that dissent has proven prophetic, and the inconsistencies and aggressive positions among State courts and taxing agencies in applying and interpreting *Allied-Signal* is due to the lack of definitive legal standards for determining when an asset serves an operational function versus an investment function. In light of the manifest burdens that have been imposed and continue to be imposed by the decision below on interstate commerce, *see* Section III below, it is essential for this Court to review this case and to resolve the question of how the operational function language under *Allied-Signal* should be interpreted and applied by the states.

III. IF LEFT IN PLACE, THE DECISION OF THE CALIFORNIA SUPREME COURT WILL SERIOUSLY UNDERMINE CONSTITUTIONAL RESTRAINTS ON STATE TAXATION

The California Supreme Court decision below poses a serious threat to constitutional restraints on state taxation. The decision below is contrary to a fundamental guiding principle under the Due Process and Commerce Clauses that in order for a state such as California to tax the multistate income of a nondomiciliary corporation, there must be a "minimal connection" between the interstate activities and the taxing state, and there must be a "rational relationship" between the income attributed to

the taxing states and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980). The decision below is also contrary to the guiding principle that "a State may not tax value earned outside its borders." *ASARCO, supra*, 458 U.S. at 315.

The impact of the California Supreme Court's decision is not merely theoretical. If the decision below stands, it will pave the way for every state to avoid the constitutional limitations on its taxing powers. The decision below stands for a proposition of astonishing breadth: A state may constitutionally apportion income of a corporation, in the complete absence of any unitary ties, so long as the capital transaction producing such income helps the corporation "make better use" of its business-related asset. Under California's definition of an operational function, in the opinion below, virtually all income from a capital transaction, passive investment or otherwise, will be considered operational so long as it has something to do with the business of the taxpayer. Contrast California's position to that of the contemporaneous opinion of the North Carolina Supreme Court in *Union Carbide v. Offerman*, 526 S.E.2d 167 (N.C. 2000), where under nearly identical facts, and interpreting a nearly identical statute to California's "business income" statute, the highest court of North Carolina held a pension reversion was not taxable by North Carolina.

In short, the decision below has implications not only for California, but for every state and for every taxpayer that conducts business across state lines. Unless reviewed by this Court, the decision below will allow California to tax income that is far beyond its constitutional reach, and

the decision below is likely to embolden other states to follow California's lead. In these circumstances, this Court should grant review.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX A

IN THE SUPREME COURT OF CALIFORNIA

HOECHST CELANESE CORPORATION, Plaintiff and Appellant, v. FRANCHISE TAX BOARD, Defendant and Respondent.	))))))))	S085091 (Filed May 14, 2001) Ct.App. 3 C030702 Sacramento County Super.Ct.No. 96AS01954

States have long struggled to devise an equitable and constitutional method for taxing corporations that do business in multiple states and countries. Like many other states, California has adopted the Uniform Division of Income for Tax Purposes Act (7A pt. 1 West's U. Laws Ann. (1999) U. Div. of Income for Tax Purposes Act, § 1 et seq., p. 361) (UDITPA) in an attempt to resolve this dilemma (see Rev. & Tax. Code, §§ 25120-25141).[1] Under this scheme of taxation, all taxpayer income is divided into business or nonbusiness income. Business income is apportionable to each state using a three-factor formula. Nonbusiness income is allocable only to the taxpayer's commercial domicile. In this case, we consider whether a reversion of surplus pension plan assets is taxable by California as apportionable business income. We conclude that it is.

SEE DISSENTING OPINION

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[1] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

Factual Background

Hoechst Celanese Corporation (Hoechst), formerly Celanese Corporation, is a Delaware corporation with its principal place of business in New Jersey and its commercial domicile in New York. It manufactures and sells a diversified line of chemicals, fibers and specialty products. Since the late 1960's, Hoechst has conducted business operations in California and filed California franchise tax returns.

In 1947, Hoechst created its first pension plan. Since then, Hoechst's pension plans have undergone numerous changes. For example, the original pension plan required contributions from both Hoechst and its participating employees. In 1969, however, the plan became noncontributory, and only Hoechst had to make contributions. Despite the constant evolution of these plans, their purpose has remained the same. Hoechst has created and maintained these plans "for the general benefit of its employees" in an effort to "retain its current employees and to attract other qualified employees."

The version of the pension plan at issue here was known as the Celanese Retirement Income Plan (CRIP I), and was subject to the terms of the Employee Retirement Income Security Act of 1974 ([sic] U.S.C. § 1001 et seq.) (ERISA). CRIP I dated back to the original 1947 plan and resulted from the merger in 1982 of several pension plans created and maintained by Hoechst and its controlled subsidiaries. It was a qualified plan under Internal Revenue Code section 401(a) (26 U.S.C. § 401(a)) and covered

both active and retired employees. Under the terms of CRIP I, each plan member only had a "nonforfeitable right" to a predefined level of benefits. (*Hughes Aircraft Co. v. Jacobson* (1999) 525 U.S. 432, 440 (*Hughes Aircraft*).)

In conjunction with CRIP I, Hoechst created and maintained a trust known as the Celanese Retirement Income Plan Trust (CRIP Trust I). The trust was tax exempt, and Chase Manhattan Bank acted as the trustee. To fund CRIP I, Hoechst made periodic contributions to the CRIP Trust I, and the trust invested these contributions in order to insure adequate funding for the pension plan. These contributions discharged Hoechst's financial obligations and liabilities to CRIP I subject to any limitations imposed by ERISA. As permitted by law, Hoechst claimed tax deductions for these contributions on its federal and California tax returns. Any surplus assets in excess of those necessary to meet any obligations and liabilities owed under ERISA and CRIP I (surplus pension plan assets) were used to reduce future contributions by Hoechst to the CRIP Trust I and were not used to increase any benefits provided under the plan.

Because the CRIP Trust I held the pension plan assets, Hoechst did not own or hold legal title to these assets and could not use these assets to fund any of its corporate activities. Hoechst, however, retained an interest in any surplus pension plan assets. These surplus assets would revert to Hoechst *only* upon termination of the plan and satisfaction of all benefits and liabilities owed under CRIP I and ERISA. Until such a reversion, none of the pension plan assets, including any contributions or capital gains, were taxable as Hoechst's income.

Even though Hoechst did not hold legal title to the pension plan assets, it did have some control over them through its power over CRIP I and the CRIP Trust I and their predecessors. For example, Hoechst had the power to amend or discontinue the pension plans at any time, subject to ERISA limitations. The board of directors of Hoechst also had the power to appoint and replace the trustees of the pension plan assets at any time – a power that it exercised on numerous occasions.

Hoechst also retained the power to administer its pension plans, including the power to prescribe procedures to follow in obtaining evidence necessary to establish the right of any person to payments under the plans, to interpret the terms of the plans, to prescribe procedures for determining and recording the periods for calculating benefits, and to determine the right of any person to benefits under the plans. To exercise these powers, Hoechst created an administrative committee composed of Hoechst employees, including corporate officers. Known as the Employee Benefits Administration Committee, the committee handled all paperwork for the plans, determined eligibility for benefits and considered requests for increases in benefits. The committee met in either New York or North Carolina three to six times a year on an irregular basis, depending on the rate that applications accumulated.

Hoechst also created a separate committee responsible for the supervision and review of the financial operation of its pension plans and trusts. The Celanese Pension Plan Investment Committee was comprised of Hoechst's chief financial officer, some of its vice-presidents, its controller and an individual from its human resources

department. The committee established, supervised and reviewed the funding and investment policies of the plans and trusts and appointed the investment fund managers who determined the actual investments made by the plans and trusts. Although the committee did not control the specific investments chosen by the fund managers, it had the power to change fund managers and guide their overall investment strategy. On many occasions, Hoechst exercised this power and replaced these fund managers for various reasons, including inadequate performance. For example, in 1978, the committee "drastically revised" the investment strategy of its pension plan and "introduced new managers with a different perspective on their mission."

Due to years of wise investments, the CRIP Trust I accumulated more assets than necessary to fund the defined benefits owed to plan members under CRIP I and ERISA. In 1983, Hoechst decided to recapture these surplus assets in order to preclude their use in a takeover bid. To recapture the surplus assets, Hoechst divided CRIP I into two separate plans with essentially the same provisions as CRIP I. The newly created Celanese Retirement Income Plan (CRIP II) covered active employees, and the Celanese Retirement Security Plan (CRSP) covered retired employees. Like their predecessor, both plans were qualified benefit plans under Internal Revenue Code section 401(a).

Concurrent with its division of CRIP I, Hoechst divided the CRIP Trust I into two separate trusts. The Celanese Retirement Income Plan Trust (CRIP Trust II) funded the newly created CRIP II, while the Celanese Retirement Security Plan Trust (CRSP Trust) funded the

newly created CRSP. As part of the split-up, Hoechst allocated all assets of the CRIP Trust I between the CRIP Trust II and the CRSP Trust. In making this allocation, Hoechst made sure that all benefits owed to CRIP II and CRSP members were fully funded as required under the terms of CRIP I and ERISA.

Using the funds allocated to the CRSP Trust, Hoechst purchased annuities to provide the benefits owed to its retirees. Hoechst then terminated both CRSP and the CRSP Trust in 1985. Upon termination, all surplus assets of that plan and trust reverted to Hoechst. This surplus totaled approximately $388.8 million. After the reversion, Hoechst placed these surplus pension plan assets in its general fund to be used for general corporate purposes.

As part of its 1985 federal tax returns, Hoechst reported the income from the reversion as "miscellaneous income." Hoechst also reported the income from the reversion as "taxable income of the business" in its 1985 New York tax return, and paid New York state income tax on a small percentage of this income.[2] In its 1985 California tax return, however, Hoechst did not apportion any part of the reverted income to California. Consequently, the State Franchise Tax Board (Board) issued a "Notice of Additional Tax Proposed to Be Assessed for 1985" and proposed to impose an additional franchise tax of $292,142 plus interest based on the income from the reversion.

Hoechst filed a timely protest. The Board denied the protest and affirmed the proposed assessment in its

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[2] New York has not adopted the UDITPA.

entirety. Hoechst then appealed to the State Board of Equalization (SBE). Citing *Appeal of Borden, Inc.* (Feb. 3, 1977) (1971-1978 Transfer Binder) Cal.Tax Rptr. (CCH) paragraph 205-515, page 14,897- 57 (*Borden*), and *Appeal of Kroehler Manufacturing Co.* (Apr. 6, 1977) (1971-1978 Transfer Binder) Cal.Tax Rptr. (CCH) paragraph 205-646, page 14,897-122 (*Kroehler*), the SBE held that: (1) the definition of "business income" in subdivision (a) of section 25120 created both a transactional and a functional test; and (2) income from the reversion was business income under the functional test. Thus, the reverted income was apportionable and subject to taxation in California. The SBE also found the tax assessment constitutional under the operational purpose test enunciated in *Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 778 (*Allied-Signal*).

Hoechst then filed a timely claim for refund with the Board. As part of the claim, Hoechst attached a check for $715,791.35 – which covered the original assessment plus interest. In the claim, Hoechst asked for a full refund, alleging that the income from the reversion did not constitute business income under section 25120. Hoechst further argued that apportionment of the income from the reversion to California violated the due process and commerce clauses of the United States Constitution.

After the Board denied the claim, Hoechst filed a complaint for refund of taxes with the superior court. After a hearing, the court ruled in favor of the Board. Specifically, the court found that: (1) the statutory definition of "business income" established both a transactional and a functional test; (2) the income from the reversion was apportionable business income subject to taxation in

California under the functional test; and (3) taxation of the income from the reversion by California did not violate the due process and commerce clauses of the United States Constitution.

Hoechst appealed, and the Court of Appeal reversed. Although the court applied both a transactional and functional test, it concluded that the reversion did not satisfy either test. First, the court found that the reversion did not meet the transactional test because the reversion was an extraordinary event that did not occur in the regular course of Hoechst's trade or business. Second, the court found that the reversion failed the functional test because Hoechst did not own or hold title to the pension plan assets that generated the income. Thus, the income from the reversion was nonbusiness income – and not business income – and was only subject to taxation in Hoechst's commercial domicile, New York.

We granted review to determine whether: (1) income from a reversion of surplus pension plan assets constitutes business income apportionable to California; and (2) subjecting income from a reversion to taxation in California violates the federal due process and commerce clauses.

Discussion

I

Pursuant to "the unitary business principle," a state may "tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State." (*Allied-Signal, supra,* 504 U.S. at p. 778.) California employs this " 'unitary business' principle and formula

apportionment in applying [its franchise] tax to corporations doing business both inside and outside the State." (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 162-163 (*Container Corp.*).) Under the "unitary business/formula apportionment method," a state "calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." (*Id.* at p. 165.) Like many other states that use this method of taxation, California has adopted the UDITPA almost verbatim. (*Container Corp.*, at p. 165; § 25120 et seq.)

Originally promulgated by the National Conference of Commissioners on Uniform State Laws (Commissioners) in 1957, the UDITPA has two main objectives: "(1) to promote uniformity in allocation practices among the 38 states which impose taxes on or measured by the income of corporations, and (2) to relieve the pressure for congressional legislation in this field." (Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act* (1967) 15 UCLA L.Rev. 156, 156 (Keesling & Warren).) Initially, the UDITPA received a tepid response as few states adopted it. In 1965, however, Congress proposed comprehensive legislation regulating state taxation of interstate commerce. Spurred by the specter of congressional intervention, many states, including California, adopted the UDITPA. (See Peters, *The Distinction Between Business Income and Nonbusiness Income* (1973) 25 So. Cal.

Tax Inst. 251, 279 (Peters).) Currently, 22 states plus the District of Columbia have adopted the UDITPA.[3] In addition, some states have modeled their corporate tax scheme after the UDITPA. (See, e.g., *Polaroid Corp. v. Offerman* (N.C. 1998) 507 S.E.2d 284, 294 (*Polaroid*) [North Carolina's "Corporate Income Tax Act is modeled after [the] UDITPA"]; *Kroger Co. v. Dept. of Revenue* (Ill.App.Ct. 1996) 673 N.E.2d 710, 714 (*Kroger*) [the Illinois Income Tax Act "was modeled after the UDITPA"].)

California's Uniform Division of Income for Tax Purposes Act (California UDITPA) mirrors the UDITPA. (Compare §§ 25120-25141 with 7A pt. 1 West's U. Laws Ann., *supra*, UDIPTA, §§ 1-22, pp. 361-403.) Like the UDITPA, the California UDITPA divides all corporate income into two categories – business income and nonbusiness income – and uses the UDITPA definition of these categories. (§ 25120.) " 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) " 'Nonbusiness income' means all income other than business income." (§ 25120, subd. (d).) All business income is "apportioned to this state" through a formula

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[3] These states are: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. (7A pt. 1 West's U. Laws Ann. (2000 supp.) UDITPA, note, p. 13.)

based on the property, sales and payroll of the taxpayer. (§ 25128.)[4] In contrast, nonbusiness income is generally "allocated in full to the state in which the taxpayer is domiciled." (*Robert Half Internat., Inc. v. Franchise Tax Bd.* (1998) 66 Cal.App.4th 1020, 1023 (*Robert Half*).) The tax treatment of corporate income therefore depends on its classification as business or nonbusiness income.

Because section 25120 defines "nonbusiness income" in relation to business income, the definition of "business income" is the key to determining whether corporate income is apportionable or allocable. To construe this definition, we apply the well-established rules of statutory construction and seek to " 'ascertain the intent of the Legislature so as to effectuate the purpose of the law.' " (*Wilcox v. Birtwhistle* (1999) 21 Cal.4th 973, 977 (*Wilcox*), quoting *DuBois v. Workers' Comp. Appeals Bd.* (1993) 5 Cal.4th 382, 387.) As always, we begin with the words of a statute and give these words their ordinary meaning. (*Wilcox*, at p. 977.) If the statutory language is clear and unambiguous, then we need go no further. (*Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 735.) If, however, the language is susceptible to more than one reasonable interpretation, then we look to "extrinsic aids, including the ostensible objects to be achieved, the evils to be

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[4] Since 1993, the Legislature has amended the original apportionment formula – which used to be identical to the formula used in the UDITPA. (Compare § 25128 with Stats. 1966, ch. 2, § 7, p. 179.) The present formula, however, is still based on the property, sales and payroll of the taxpayer. (See § 25128.)

remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part." (*People v. Woodhead* (1987) 43 Cal.3d 1002, 1008.) Where the Legislature adopts a uniform act, the history surrounding the creation and adoption of that act is also relevant.[5] (See *In re Marriage of Bonds* (2000) 24 Cal.4th 1, 16-19 (*Bonds*).)

In the instant case, Hoechst contends the statutory definition of "business income" creates a single transactional test, and the 1985 reversion of surplus pension plan assets does not satisfy this test or any other test. Thus, the income from the reversion is nonbusiness income that is only taxable by Hoechst's commercial domicile, New York. The Board counters that the definition establishes

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[5] In three separate requests for judicial notice, the Board asked the court to take judicial notice of: (1) a Bill Analysis and Fiscal Impact Report submitted by the New Mexico Taxation and Revenue Department in connection with New Mexico House Bill No. 349 (1999 Reg. Sess.); (2) a transcript of the January 12, 1996, hearing of the California Assembly Committee on Taxation; (3) the 1966 reprinting of the model UDITPA issued by the National Conference of Commissioners on Uniform State Laws; (4) the legislative history of Assembly Bill No. 11 (1966 Reg. Sess.), which became the California UDITPA; (5) a January 7, 1966 memorandum from Allison Dunham, the Executive Director of the National Conference of Commissioners on Uniform State Laws, to the Special Committee on UDITPA; and (6) a January 21, 1966 memorandum from William J. Pierce, a commissioner of the National Conference of Commissioners on Uniform State Laws, to the Special Committee on UDITPA. In addition, Hoechst asked the court to take judicial notice of a January 14, 1966 memorandum from Donald H. Burnett to R.R. Bullivant, Chairman of the Special Subcommittee on UDITPA. We hereby grant these requests. (Evid.Code, § 452, subd. (h).)

both a transactional and functional test, and the reversion meets both tests. Thus, the reverted assets are apportionable to California. As explained below, we conclude that the statutory definition establishes separate transactional and functional tests for business income and that the reversion satisfies *only* the functional test. Therefore, the income from the reversion is apportionable business income.

A. The Business Income Tests

Subdivision (a) of section 25120 states: " 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Thus, the statutory definition of "business income" consists of two clauses joined together by the conjunction and predicate, "and includes." (*Ibid.*) In interpreting this language, all courts agree that the first clause establishes a transactional test. Some courts have, however, construed the second clause as a separate functional test for business income. (*Uniroyal Tire Co. v. Dept. of Finance* (Ala. 2000) 779 So.2d 227, 230 (*Uniroyal Tire*).) Under this construction, corporate income is business income if it satisfies either the transactional or functional test. (*Ibid.*) Other courts have rejected this approach and construed the two clauses as a single transactional test. Under this construction, the second clause modifies the first clause and merely exemplifies "what fits within the definition."

(*Polaroid, supra*, 507 S.E.2d at p. 290.) Not surprisingly, Hoechst contends the statutory definition of business income establishes only a transactional test, while the Board contends the definition establishes both a transactional and functional test. We agree with the Board.

We initially note that the statutory language is ambiguous and reasonably susceptible to either interpretation. On the one hand, the grammatical structure of the business income definition arguably creates both a transactional and functional test. " 'Business income' " is the subject of the sentence. (§ 25120, subd. (a).) Two predicate clauses containing different verbs, objects and prepositional phrases and separated by a conjunction follow this subject. As such, the definition arguably contains a "compound predicate" that states two independent definitions of business income. (*Kroger, supra*, 673 N.E.2d at p. 713.) In other words, "the statute could grammatically be read as stating: 'Business income means income arising from transactions and activity in the regular course of the corporation's trade or business, and [business income] includes income from tangible and intangible property. . . . ' " (*Polaroid, supra*, 507 S.E.2d at pp. 297-298.)

Such an interpretation accords with the different language used in the first and second clauses. The first clause focuses on "transactions and activity" and their relationship to "the regular course of the taxpayer's trade or business." (§ 25120, subd.(a).) In contrast, the second clause focuses on "property" and its relationship to "the taxpayer's regular trade or business operations." (*Ibid.*) The creation of two separate predicate clauses with different verbs, objects and prepositional phrases strongly

suggests that "the second clause contains a definition distinct from that set forth in the first." (*Polaroid, supra,* 507 S.E.2d at p. 298.) The apparent expansion of "the definition of business income" by the second clause bolsters such a conclusion because a broader definition can hardly exemplify a narrower definition. (*Kroger, supra,* 673 N.E.2d at p. 713.)

On the other hand, the addition of the word "includes" after the conjunction linking the two clauses suggests that the second clause is a subset of the first clause under the last antecedent doctrine. (§ 25120, subd. (a).) According to this doctrine, " 'qualifying words, phrases and clauses are to be applied to the words or phrases immediately preceding and are not to be construed as extending to or including others more remote.' " (*White v. County of Sacramento* (1982) 31 Cal.3d 676, 680, quoting *Board of Port Commrs. v. Williams* (1937) 9 Cal.2d 381, 389.) Arguably, the word "includes" makes the second clause a qualifying clause that modifies the first clause – and not just "business income." (*Uniroyal Tire, supra,* 779 So.2d at p. 232.) In other words, "[t]he concluding twenty-six words . . . are added to include transactions involving disposal of fixed assets by taxpayers *who emphasize the trading of assets as an integral part of regular business.*" (*Phillips Petroleum Co. v. Iowa Dept. of Rev. & Fin.* (Iowa 1994) 511 N.W.2d 608, 610, italics added (*Phillips Petroleum*).)

The language of the second clause provides some support for such an interpretation. The second clause states that the "acquisition, management, *and* disposition" of property must be "integral parts" of the taxpayer's "regular" "business operations." (§ 25120, subd.

(a), italics added.) The use of "and" suggests that the second clause merely exemplifies the first because the sale of property " 'that is not regularly disposed of, but rather is held indefinitely,' " arguably cannot be an integral part of the taxpayer's business operations. (*Uniroyal Tire, supra,* 779 So.2d at p. 234, quoting Faber, *When Does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes?* (May-June 1995) The Tax Executive 179, 187.)

Moreover, the apparent breadth of the second clause equally supports the rejection of the functional test. As the Alabama Supreme Court observed: "If income is business income under the transactional test, then, a fortiori, it is business income under the functional test. In other words, the functional test would include everything that the transactional test includes – and much more." (*Uniroyal Tire, supra,* 779 So.2d at pp. 235-236.) As such, construing section 25120 to create two alternative tests for business income arguably renders the first clause mere surplusage, in violation of the rules of statutory construction. (See *People v. Cruz* (1996) 13 Cal.4th 764, 782.)

In light of these competing arguments, we conclude that the statutory language is ambiguous as to the existence of a separate functional test. At a minimum, we cannot find that either interpretation is unreasonable based solely on the statutory language. Indeed, the conflicting opinions of our sister courts interpreting the very same language demonstrate that reasonable minds may disagree over whether the business income definition

creates a functional test.[6] Therefore, we must now turn to extrinsic aids in an effort to ascertain the Legislature's intent. These aids establish that the Legislature intended to create both a transactional and functional test for business income.

As an initial matter, the legislative history behind the UDITPA strongly supports the inclusion of a functional test. Because the Legislature adopted the UDITPA almost verbatim (Keesling & Warren, *supra*, 15 UCLA L.Rev. at p. 156), we look to the history behind the UDITPA for guidance (see *Bonds, supra*, 24 Cal.4th at pp. 16-19). This history reveals that the UDITPA definition of "business income" derives from "California decisional law" which

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[6] Compare *Uniroyal Tire, supra*, 779 So.2d at p. 236 (transactional test only); *Phillips Petroleum, supra*, 511 N.W.2d at page 610 (same); *Western Natural Gas Co. v. McDonald* (Kan. 1968) 446 P.2d 781, 783 (*Western Natural Gas*) (same); *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue* (N.M.Ct.App. 1975) 543 P.2d 489, 492 (*McVean*) (citing the functional test language but applying the principles of the transactional test); *Associated Partnership I, Inc. v. Huddleston* (Tenn. 1994) 889 S.W.2d 190, 195 (*Associated Partnership I*) (transactional test only), with *Pledger v. Getty Oil Exploration Co.* (Ark. 1992) 831 S.W.2d 121, 124-125 (*Pledger*) (applying a separate functional test); *Dist. of Columbia v. Pierce Associates, Inc.* (D.C. 1983) 462 A.2d 1129, 1131 (*Pierce Associates*) (same); *Texaco-Cities Service Pipeline Co. v. McGaw* (Ill. 1998) 695 N.E.2d 481, 485 (*Texaco-Cities*) (same); *Montana Dept. of Revenue v. American Smelting and Refining Co.* (Mont. 1977) 567 P.2d 901, 907 (*American Smelting*) (same); *Polaroid, supra*, 507 S.E.2d at page 295 (same); *Simpson Timber Co. v. Dept. of Revenue* (Or. 1998) 953 P.2d 366, 369 (*Simpson Timber*) (same); *Ross-Araco Corp. v. Commonwealth of Pennsylvania* (Pa. 1996) 674 A.2d 691, 696-697 (*Ross-Araco*) (same).

employed a separate functional test for business income. (Peters, *supra*, 25 So. Cal. Tax Inst. at p. 278.)

The first draft of the UDITPA did not distinguish between business and nonbusiness income. (Peters, *supra*, 25 So. Cal. Tax Inst. at pp. 272-273.) After concerns about the constitutionality of the first draft arose, John S. Warren, a California tax administrator, suggested that the Commissioners divide all income into apportionable business income and allocable nonbusiness income. As part of his suggestion, Warren proposed a definition of business income based on language used in certain SBE decisions. (*Id.* at pp. 275-276.) The Commissioners liked Warren's proposal, and "[t]he final draft of the [UDITPA] contained the definitions of business income and nonbusiness income proposed by Mr. Warren." (Peters, at p. 276.) Thus, the UDITPA's definition of business income was based on pre-UDITPA decisions of the SBE, and the UDITPA's distinction between business and nonbusiness income was "in line with . . . California practice" at the time of its enactment. (Keesling & Warren, *supra*, 15 UCLA L.Rev. at pp. 163-164; see also *Polaroid*, *supra*, 507 S.E.2d at p. 294 ["the uniform definition of business income, as set forth in UDITPA, finds its origins in early California jurisprudence"].) Accordingly, our interpretation of the business income definition should be guided by the SBE's pre-UDITPA decisions applying language similar to the language of the UDITPA.

These SBE decisions consistently applied an *independent* functional test when determining whether income constituted business income. In doing so, the SBE used language virtually identical to the language in the second clause of the statutory definition. For example, in *Appeal*

of Marcus-Lesoine, Inc. (July 7, 1942) 2 SBE 338, 340-341 (*Marcus-Lesoine*), the SBE held that interest income from conditional sales contracts constituted business income *solely* because "the acquisition, management and liquidation of the intangibles constitute[d] integral parts of the corporation's regular business operations." Similarly, the SBE found that copyright royalties were business income *solely* because the "acquisition, management and disposition of the intangibles constitute[d] integral parts of the corporation's regular business operations." (*Appeal of Houghton Mifflin Co.* (Mar. 28, 1946) 3 SBE 344, 345 (*Houghton Mifflin*).) The SBE also relied *solely* on the functional test when it held that patent royalties constituted business income. (*Appeal of National Cylinder Gas Co.* (Feb. 5, 1957) 6 SBE 153, 154 ["We have consistently held . . . that income from intangibles is includible in unitary income and subject to [apportionment] if the acquisition, management and disposition of the intangibles constitute integral parts of the unitary business"]; *Appeal of Intern. Business Machines Corp.* (Oct. 7, 1954) 6 SBE 5, 6-7 ["we have previously held that income from such intangibles [patents] is subject to [apportionment] where the acquisition, management and disposition of the intangibles constitute integral parts of the owner's regular business operations"].) Because these SBE decisions construe the language of the second clause as an independent test for business income, we hold that a separate functional test exists.

The comments to section 1, subdivision (a) of the UDITPA prepared by the Commissioners (Commissioners Comments) bolster our holding. The comment states in part that "[i]ncome from the disposition of property used

in a trade or business of the taxpayer is includible within the meaning of business income." (Comrs. Com., UDITPA, com. foll. § 1, subd.(a), p. 2, reprinted at <http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/udiftp57.htm> [as of May 14, 2001].) By focusing on the "property" and its relationship to the "trade or business" and using the "disposition" language of the second clause (*ibid.*), the Commissioners Comment strongly suggests that a separate functional test for business income exists. Indeed, the comment ostensibly makes all income from the disposition of property used in the taxpayer's business apportionable even if the disposition does not occur "in the regular course of the taxpayer's trade or business." (7A pt. 1 West's U. Laws Ann., *supra*, UDITPA, § 1, subd. (a), pp. 361-362.)

Administrative decisions interpreting the statutory definition of "business income" also support the inclusion of a separate functional test. Although we are not bound by administrative decisions construing a controlling statute, we accord " 'great weight and respect to the administrative construction.' " (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12 (*Yamaha*), quoting *International Business Machines v. State Bd. of Equalization* (1980) 26 Cal.3d 923, 931, fn. 7.) The amount of deference given to the administrative construction depends " 'upon *the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.*' " (*Yamaha*, at pp. 14-15, italics added by *Yamaha*, quoting *Skidmore v. Swift & Co.* (1944) 323 U.S. 134, 140.)

In light of these considerations, we find the SBE decisions construing the language of the second clause of the statutory business income definition as an independent functional test for business income highly persuasive. In *Borden, supra,* (1971-1978 Transfer Binder) Cal.Tax Rptr. (CCH), paragraph 205-616, page 14,897-59, the SBE first addressed the validity of the functional test and held that section 25120 authorized a separate "functional test for business income." In a thorough and well-reasoned opinion, the SBE discussed the legislative history behind the UDITPA and relied heavily on those California administrative decisions that formed the basis for the business income definition. (*Borden,* at pp. 14,897-58 to 14,897-59.) The SBE also cited language in regulations proposed by the Multistate Tax Commission and enacted in California that supported the existence of a separate functional test. (*Id.* at p. 14,987-59.) Finally, the SBE rejected the contrary conclusion reached by the Kansas and New Mexico courts in *Western Natural Gas, supra,* 446 P.2d at page 783, and *McVean, supra,* 543 P.2d at page 492, because these courts did not consider the UDIPTA's history or the regulations. (*Borden,* at p. 14,897-59.) During the 24 years since *Borden,* the SBE has consistently applied both a transactional and functional test when determining whether income constitutes business income under subdivision (a) of section 25120.[7] Because the SBE

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[7] (See, e.g., *Appeal of CTS Keene, Inc.* (Feb. 10, 1993) [1993-1995 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 402-589, p. 27,569; *Appeal of Dial Finance Co. of Cal.* (Feb. 10, 1993) [1993-1995 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 402-586, p. 27,553; *Appeal of American Biltrite Inc.* (Nov. 19, 1992) [1991-1992 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 402-531, p. 27,407-3;

thoroughly considered the issue, reached a reasonable conclusion, and consistently applied this conclusion over the past 24 years, we see no reason to overturn the SBE's longstanding construction. (See *Yamaha, supra,* 19 Cal.4th at pp. 12-15.)

Appeal of VSI Corp. (May 2, 1991) [1991-1992 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-937, p. 26,240 (*VSI Corp.*); *Appeal of Masonite Corp.* (Nov. 15, 1988) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-677, p. 25,335; *Appeal of R.H. Macy & Co.* (July 26, 1988) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-639, p. 25,195; *Appeal of U-Haul Co. of Van Nuys* (Mar. 3, 1987) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-489, p. 24,667; *Appeal of Mark Controls Corp.* (Dec. 3, 1986) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-451, p. 24,566 (*Mark Controls*); *Appeal of National Dollar Stores, Inc.* (Sept. 10, 1986) [1984-1986 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-403, p. 24,429 (*National Dollar Stores*); *Appeal of Armour Oil Co.* (June 10, 1986) [1984-1986 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-355, p. 24,325; *Appeal of Southwestern Development Co.* (Sept. 10, 1985) [1984-1986 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-157, p. 23,898; *Appeal of Calvo Growers of Cal.* (Feb. 28, 1984) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-673, p. 23,035; *Appeal of Johns-Manville Sales Corp.* (Aug. 17, 1983) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-476, p. 22,741; *Appeal of Amwalt Group, Inc.* (July 28, 1983) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-433, p. 22,693 (*Amwalt Group*); *Appeal of Occidental Petroleum Corp.* (June 21, 1983) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-394, p. 22,609 (*Occidental Petroleum*); *Appeal of Standard Oil Co. of Cal.* (Mar. 2, 1983) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-383, p. 22,561 (*Standard Oil*); *Appeal of DPF, Inc.* (Oct. 28, 1980) [1978-1981 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 206-429, p. 14,965-36; *Kroehler, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-646, p. 14,897-122; *Appeal of New York Football Giants, Inc.* (Feb. 3, 1977) [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-600, p. 14,897-31 (*New York Football Giants*).)

Finally, construing the second clause of the definition as a separate functional test fulfills one of the primary objectives behind the UDITPA – to promote uniformity among the states. (Keesling & Warren, *supra*, 15 UCLA L.Rev. at p. 156.) Although courts in other jurisdictions that have adopted the UDITPA have disagreed over the existence of a separate functional test, the state legislatures in these jurisdictions have not. In four of the five states where the state court rejected the functional test, the state Legislature amended the definition of business income to include such a test.[8] (See Iowa Code, § 422.32; Kan. Stat., § 79-3271, subd. (a) [taxpayer may elect to apply the functional test]; N.M. Stat., § 7-4-2, subd. A; Tenn. Code, § 67-4-2004.) Thus, virtually all states adopting the UDITPA now construe the second clause of the business income definition as a separate functional test. In the interests of promoting uniformity, we do the same. Accordingly, Hoechst's income from the reversion of surplus pension plan assets is apportionable as business income if it satisfies *either* the transactional test or the functional test.

B. The Transactional Test

Under the transactional test, corporate income is business income if it arises "from transactions and activity in the regular course of the taxpayer's trade or

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[8] Only Alabama has not amended its definition of business income to include a functional test. Of course, the Alabama Supreme Court only issued its decision rejecting the functional test in August 2000.

business." (§ 25120, subd. (a).) Upon construing and applying this statutory language, we conclude that Hoechst's reversion of surplus pension plan assets fails to meet the transactional test.

The language of the transactional test is unambiguous, and courts have construed this language in a consistent manner. "The controlling factor by which" the transactional test "identifies business income is the nature of the particular transaction" that generates the income. (*Western Natural Gas, supra,* 446 P.2d at p. 783.) To create business income, these "transactions and activity" must occur "in the *regular* course of the taxpayer's trade or business." (§ 25120, subd. (a), italics added.) "[R]elevant considerations include the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income." (*Associated Partnership I, supra,* 889 S.W.2d at p. 195.) "[U]nprecedented, . . . once-in-a-corporate-lifetime occurrence[s]" do not meet the transactional test because they do not occur in the regular course of any business. (*Phillips Petroleum, supra,* 511 N.W.2d at pp. 610-611.) Thus, income arising from "extraordinary" events such as a "complete liquidation and cessation of business" cannot satisfy the transactional test. (*Uniroyal Tire Co., supra,* 779 So.2d at p. 236.)

Here, the reversion and the activities necessary to execute the reversion were extraordinary occurrences. They were not normal trade or business activities of Hoechst, which manufactured and sold a diversified line of chemicals, fibers and specialty products. Indeed, the 1985 reversion of surplus pension plan assets was the first and only such transaction in Hoechst's corporate

history. Because the reversion was a "once-in-a-lifetime corporate occurrence," it cannot meet the transactional test. (*Phillips Petroleum, supra,* 511 N.W.2d at pp. 610-611.)

In reaching this conclusion, we reject the Board's attempt to define the relevant "transactions and activity" as the purchase and sale of securities by the fund managers appointed by Hoechst. (§ 25120, subd. (a).) These investments did not result in *any taxable income* to Hoechst *until and unless:* (1) the investments generated more assets than necessary to fund the defined benefits owed to plan members; and (2) Hoechst acted to recapture these surplus assets. Thus, the only transaction or activity that generated any taxable income for Hoechst was the reversion itself. Accordingly, the income from the reversion does not satisfy the transactional test and is apportionable to California only if it meets the functional test.

C. The Functional Test

Under the functional test, corporate income is business income "if the acquisition, management, and disposition of the [income-producing] property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) After reviewing the statutory language and the applicable extrinsic aids, we hold that the reversion satisfies the functional test. Therefore, the income from the reversion is business income apportionable to California.

We begin our analysis by examining the statutory language. In contrast to the transactional test, which

focuses on the income-producing "transactions and activity," the functional test focuses on the income-producing "property." (§ 25120, subd. (a).) This property may be "tangible" or "intangible" (*ibid.*), and the nature of the relationship between this property and the taxpayer's "business operations" is the critical inquiry (*Texaco-Cities, supra,* 695 N.E.2d at p. 486 [the functional test "focuses upon the role or function of the property as being integral to regular business operations"]).

Before defining the relationship necessary to meet the functional test, we reject at the outset Hoechst's contention that the statutory term "property" implies that the taxpayer must own or hold legal title to the property. Such an interpretation only considers the term "property" in isolation and ignores the conditional clause that places this term in context: "if the acquisition, management, and disposition of the *property* constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a), italics added.) This conditional clause – and not the vague implications of the term "property" – defines the relationship between the property and the taxpayer required by the functional test.

The conditional clause contains two key phrases: "acquisition, management, and disposition of the property" and "integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) The first phrase – "acquisition, management, and disposition of the property" – appears to refer to the taxpayer's interest in and power over the income-producing property. (*Ibid.*) In construing this phrase, the parties focus on the meaning of the word "and." (*Ibid.*) Hoechst contends "and" has a conjunctive meaning, while the Board contends "and"

has a disjunctive meaning in the statute. (*Ibid.*) Because "and" is ordinarily conjunctive and because nothing suggests a legislative intent to give "and" a different meaning, we agree with Hoechst. (See *Wilcox, supra,* 21 Cal.4th at p. 977.) We do not, however, end our inquiry there. Rather, we find it both instructive and necessary to consider the meaning of the terms "acquisition," "management," and "disposition" in the context of the business income definition. (§ 25120, subd. (a).)

Upon doing so, we conclude that the phrase "acquisition, management, and disposition" "refers to the conditions of ownership of property by the taxpayer." (*Kroger, supra,* 673 N.E.2d at p. 714.) Such a conclusion follows logically from the ordinary meanings of these words. At the time of the enactment of the California UDITPA, "acquisition" signified the "act of acquiring" (Webster's 3d New Internat. Dict. (1961) p. 19), and "acquire" meant "to come into possession, control, or power of disposal of" (*id.* at p. 18). "[M]anagement" referred to the "act . . . of managing," and "manage" meant "to control and direct: handle either well or ill: cope with: CONDUCT, ADMINISTER" and "to direct or carry on business or affairs: SUPERVISE, ADMINISTER." (*Id.* at p. 1372.) Finally, "disposition" denoted "*the act or the power* of disposing or disposing of" and, as relevant here, "dispose of" meant "to transfer into new hands or to the control of someone else . . . RELINQUISH, BESTOW." (*Id.* at p. 654, italics added.) In light of these definitions, the phrase "acquisition, management, and disposition of the property" establishes that the taxpayer must: (1) obtain some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have

the power to transfer, control of that property in some manner.

Under this construction, legal ownership or title to the property is not necessary. Such a limitation is too restrictive because property ownership "finds expression through multiple methods." (*Union Oil Co. v. State Bd. of Equal.* (1963) 60 Cal.2d 441, 447.) "Ownership is not a single concrete entity but a bundle of rights and privileges as well as of obligations." (*Ibid.*, fn. omitted.) Indeed, corporations often control and use property to generate business income without owning or holding legal title to that property. Consequently, we believe the phrase "acquisition, management, and disposition" encompasses the myriad of ways that corporations may control and use the rights and privileges commonly associated with property ownership.

The Commissioners Comments to the UDITPA confirm our belief. In the comment to section 1 of the UDITPA, the Commissioners state that "[i]ncome from the disposition of property" is business income if the property is "*used* in a trade or business of the taxpayer." (Comrs. Com., UDITPA, com.foll. § 1, subd. (a), p. 2, reprinted at <http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/udiftp57.htm> [as of May 14, 2001], italics added.) In making this statement, the Commissioners clearly contemplated that the functional test would focus on the taxpayer's control and use of the property and not on legalistic formulations of property ownership.

Of course, mere control and use of the income-producing property is not enough to satisfy the functional

test. Rather, the taxpayer's control and use of the property must still be "an integral part of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) The critical terms in this second key phrase of the functional test are "integral," "regular," and "operations." (*Ibid.*) As explained below, these terms establish that the taxpayer's control and use of the property must contribute materially to the taxpayer's production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business.

We begin our interpretation of this phrase by defining the terms "regular" and "operations." "[R]egular" means "NORMAL" or "TYPICAL." (Webster's 3d New Internat. Dict., *supra,* at p. 1913.) In the business context, "operations" mean "the whole process of planning for and operating a business" or "a phase of a business or of business activity." (*Id.* at p. 1581.) As such, the phrase "regular trade or business operations" is unambiguous and refers to the normal or typical business activities of the taxpayer. (§ 25120, subd. (a).)

To reach this conclusion, we reject Hoechst's contention that the word "regular" limits the functional test to normal or customary corporate events. Although "regular" has the same meaning in the transactional and functional tests, it is not used in the same way in these tests. In the transactional test – which focuses on the income-producing transaction – "regular" modifies "course of the taxpayer's trade or business" and makes the nature of the transaction relevant. (*Associated Partnership I, supra,* 889 S.W.2d at p. 195.) In the functional test – which focuses on the income-producing property – "regular" modifies "trade or business operations" and follows the

phrase "an integral part of." (§ 25120, subd. (a).) Consequently, "regular," as used in the functional test, does not refer to the nature of the transaction, and the extraordinary nature or infrequency of the income-producing transaction is irrelevant. (See *Citicorp of North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1430 (*Citicorp*); see also *Pierce Associates, supra,* 462 A.2d at p. 1131; *Texaco-Cities, supra,* 695 N.E.2d at p. 484; *Polaroid, supra,* 507 S.E.2d at p. 289; *Ross-Araco, supra,* 674 A.2d at p. 693.)

Thus, the phrase "regular trade or business operations" (§ 25120, subd. (a)) establishes that the taxpayer's control and use of the income-producing property must be part of the taxpayer's normal or typical business activities. The statutory term "integral" then provides the touchstone for determining whether the property has a close enough relationship to the taxpayer to satisfy the functional test. (*Ibid.*) Not surprisingly, the parties disagree over the meaning of "integral." (*Ibid.*) Hoechst contends "integral" means "necessary or essential to." The Board counters that "integral" only means "contributing to." We, however, find neither interpretation to be accurate. Instead, we hold that "integral" requires an organic unity between the taxpayer's property and business activities whereby the property contributes materially to the taxpayer's production of business income.[9]

As an initial matter, we note that the dictionary definition of "integral" arguably supports both parties'

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[9] In describing the functional test in terms of the production of *business income,* we mean the production of income that unquestionably fits within the statutory definition of business income.

positions. As defined by Webster's Third International Dictionary, *supra*, at page 1173, "integral" means "of, *relating to*, or serving to form a whole: *essential to* completeness: organically joined or linked: CONSTITUENT, INHERENT." (Italics added.) The relevant case law also lends support to both interpretations. On the one hand, we have suggested that "integral" means " 'dependent upon or contributes to' " in the multistate taxation context. (*Superior Oil Co. v. Franchise Tax Bd.* (1963) 60 Cal.2d 406, 413-414, quoting *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481.) On the other hand, other jurisdictions have used the "essential to" language when construing the functional test. (See, e.g., *Texaco-Cities, supra*, 695 N.E.2d at p. 485; *Union Carbide Corp. v. Offerman* (N.C. 2000) 526 S.E.2d 167, 171 (*Union Carbide*).)

Nonetheless, we believe that both interpretations are problematic and do not capture the true meaning of "integral." (§ 25120, subd. (a).) Construing "integral" as "contributing to" makes the test too expansive and creates constitutional problems. Although property that is integral to a taxpayer's business undoubtedly contributes to that business, "integral" must imply something more than a mere contribution. Otherwise, the functional test would encompass all corporate transactions and run afoul of the constitutional limits on state taxation. (See *ASARCO, Inc. v. Idaho State Tax Com.* (1982) 458 U.S. 307, 326 (*ASARCO*) [property must do more than contribute to the taxpayer's business in order to be taxed by a state].) Construing "integral" as "necessary or essential to," however, is too restrictive. Under this interpretation, many sales of corporate property could not satisfy the functional test because a corporate taxpayer presumably will

not sell property unless the property is no longer necessary or essential to its business. Such an outcome conflicts with the explanatory comments to the UDITPA which contemplate the apportionment of gains realized from any sale of property used in the taxpayer's trade or business. (Comrs. Com., UDITPA, com. foll. § 1, subd. (a), p. 2, reprinted at <http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/udiftp57.htm> [as of May 14, 2000].)

Thus, the meaning of "integral" must fall somewhere in between these two interpretations. In forging this middle ground, we once again look to the SBE decisions underlying the functional test for guidance. (See *ante*, at p. 18; see also Keesling & Warren, *supra*, 15 UCLA L.Rev. at pp. 163-164; *Polaroid, supra*, 508 S.E.2d at p. 294.) These decisions reveal that the meaning of "integral" comes from our decision in *Holly Sugar Corp. v. Johnson* (1941) 18 Cal.2d 218 (*Holly Sugar*). (See *Houghton Mifflin, supra*, 3 SBE at p. 346 [relying on *Holly Sugar*].) In *Holly Sugar*, we held that losses suffered by a taxpayer from the forced liquidation of stock were apportionable because "the stockholding was an integral part of [the taxpayer's] unitary sugar business." (*Holly Sugar*, at p. 225.) The stockholding was "integral" because it could not "reasonably be characterized as an extraneous investment separate and apart from the California business" of the taxpayer. (*Id.* at p. 224.) Rather, "the activities of the two companies" constituted "one indivisible, composite whole, each portion giving value to every other portion." (*Ibid.*) Because of "this organic unity of operation," we regarded the liquidation of the stockholding as an "integral" part of the unitary business of the taxpayer. (*Id.* at pp. 224-225.)

In the context of the business income definition, the word "integral" therefore refers to an "organic unity" between the income-producing property and the taxpayer's business activities. (*Holly Sugar, supra,* 18 Cal.2d at p. 224.) The property must be so interwoven into the fabric of the taxpayer's business operations that it becomes "indivisible" or inseparable from the taxpayer's business activities with both "giving value" to each other. (*Ibid.*) Such a relationship exists when the taxpayer controls and uses the property to contribute materially to the taxpayer's production of business income. (See *Borden, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-616, p. 14,897-59; *New York Football Giants, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-600, p. 14,897-33.) In this way, we capture the true meaning of "integral." (See Webster's 3d Internat. Dict., *supra,* at p. 1173 ["integral" means "serving to *form a whole:* essential to *completeness: organically joined or linked*" (italics added)].)

Forming these interpretations of the statutory language into a cohesive whole, we conclude that income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations. Such an interpretation of the functional test flows from the ordinary meaning of the statutory language and the California decisions that formed the basis for the UDITPA definition of "business income."

We further note that our interpretation is consistent with Court of Appeal decisions applying the functional test. For example, the Court of Appeal has found business income where the income-producing property contributed materially to the taxpayer's production of business income. In *Citicorp,* the court held that income from a taxpayer's sale of buildings constituted business income under the functional test because "the buildings were constructed or acquired to serve as important locations for [the taxpayer's business] operations." (*Citicorp, supra,* 83 Cal.App.4th at pp. 1429-1430.) Thus, the court premised its finding of business income on the buildings' material contribution to the taxpayer's production of business income and concluded that the buildings were an indivisible part of the taxpayer's business operations. (See *ibid.;* see also *Times Mirror Co. v. Franchise Tax Bd.* (1980) 102 Cal.App.3d 872, 877-878 [income from the taxpayer's sale of a subsidiary's stock was business income because the subsidiary generated business income].)

In contrast, the Court of Appeal has found nonbusiness income where the taxpayer's control and use of the property did not contribute materially to the generation of business income. In *Robert Half,* the court found that losses incurred from the repurchase of a stock warrant constituted nonbusiness income. (*Robert Half, supra,* 66 Cal.App.4th at p. 1028.) Although the court mistakenly focused on the extraordinary nature of the transaction (see *id.* at p. 1025), it reached the correct result. The taxpayer's control and use of the warrants did not contribute materially to the production of any business income and were separate and distinct from the taxpayer's business operations. Therefore, losses from the

repurchase of the warrants did not satisfy the functional test.

Our interpretation of the functional test also accords with the SBE's interpretation over the past two decades. On the one hand, the SBE has consistently found business income under the functional test where the taxpayer's control and use of the property contributed materially to the production of business income and became an indivisible part of the taxpayer's business. For example, the SBE found that losses from the sale of goodwill constituted business income because the taxpayer's acquisition and maintenance of this goodwill "contributed materially to the production of business income." (*Borden, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-616, p. 14,897-59.) The SBE also held that compensation received for the loss of exclusive territorial rights constituted business income because these rights were "an important aspect of the business" and "contributed materially to the production of business income." (*New York Football Giants, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-600, p. 14,897-33.) Similarly, the SBE found that dividends from a joint venture were business income because these ventures "contributed materially to the production of operating income . . . and clearly served to further the operation of" the taxpayer's business. (*Standard Oil, supra,* [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-383, at p. 22,571.) Finally, the SBE held that income from stock sales constituted business income because "the assets and activities represented by the stock were fully integrated and functioning parts of [the taxpayer's] existing unitary business."

(*Occidental Petroleum, supra,* [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-394, p. 22,616.)

On the other hand, the SBE has consistently refused to find business income under the functional test where the taxpayer's control and use of the property did not contribute materially to the production of business income and were separate from the taxpayer's business. For example, the SBE found that rental income from a condominium constituted nonbusiness income because the rental business had no connection to the taxpayer's architectural business. (*Amwalt Group, supra,* [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-433, p. 22,696.) Similarly, the SBE held that income from the sale of stock in a company constituted nonbusiness income where the taxpayer exercised no control over and received no special benefits from that company. (*Mark Controls, supra,* [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-452, p. 24,569.) Finally, the SBE held that property used to obtain tax benefits did not give rise to business income because the property did not contribute to the production of business income and was not connected to any business activity of the taxpayer. (*VSI Corp., supra,* [1991-1992 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-937, pp. 26,241 to 26,242; *National Dollar Stores, supra,* [1984-1986 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-403, p. 24,432.)

Finally, our interpretation is largely consonant with the decisions of other jurisdictions that have adopted the functional test. These jurisdictions have focused on the taxpayer's use of the property and typically find business income where the taxpayer uses that property to produce business income. (See, e.g., *Pierce Associates, supra,*

462 A.2d at p. 1132 [insurance proceeds for flood damage to manufacturing facility used by the taxpayer to generate business income]; *Texaco-Cities, supra,* 695 N.E.2d at pp. 486-487 [income from sale of pipeline and related assets used by the taxpayer to produce business income]; *American Smelting, supra,* 567 P.2d at pp. 907- 909 [royalties from patents developed and used by the taxpayer, income from leases of mines and rental of homesites to workers, interest income from short-term investments, income from sale of stock in companies used by the taxpayer for access to raw materials or as customers]; *Simpson Timber, supra,* 953 P.2d at pp. 369-370 [proceeds from condemnation of timbered property used by the taxpayer as a source of raw materials].) These jurisdictions, however, refuse to find business income where the taxpayer has no control over the property or does not use the property in the production of business income. (See, e.g., *Pledger, supra,* 831 S.W.2d at p. 125 [interest income from intercorporate note passively held and not controlled by the taxpayer]; *Ross-Araco, supra,* 674 A.2d at p. 697 [income from sale of land never improved or used by the taxpayer]; *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania* (Pa. 1994) 642 A.2d 472, 475 [income from sale of pipeline not used by the taxpayer for over three years].)

Having established the contours of the functional test, we now apply it to Hoechst's reversion of surplus pension plan assets and conclude that the reversion meets this test. In reaching this conclusion, we find two SBE decisions instructive. In *Appeal of American Snuff Co.* (Apr. 20, 1960) [1959-1962 Transfer Binder] Cal.Tax Rptr. (CCH) paragraph 201-538, page 12,053 (*American Snuff*), the SBE

held that interest income from loans made to the taxpayer's employees constituted business income under the functional test. Because the taxpayer made these loans "for the purpose of increasing the efficiency of the employees and they, accordingly, contributed to the operations of the unitary business," the SBE concluded that "the acquisition, management and disposition of" the loans "constitute[d] integral parts of the" taxpayer's "regular business operations." (*Ibid.*) Seventeen years later, the SBE applied the same reasoning and found that a rebate of surplus funds in a retirement plan constituted business income. (*Kroehler, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-647, p. 14,897-123.) Because the plan served "[a]s an inducement to retain the current employees of the Furniture Division and to attract other qualified employees," and because employees were necessary to conduct the taxpayer's business operations, the SBE held that the "acquisition, management, and disposition of" the plan "constitute[d] integral parts of [the taxpayer's] manufacturing and sales business." (*Ibid.*)

Taken together, these decisions establish that property maintained and used by a taxpayer to retain and attract employees is integral to the taxpayer's business operations. Although these decisions are not binding, we find them especially persuasive because of their longevity, consistency and reasoning. (See *Yamaha, supra,* 19 Cal.4th at pp. 12-14.) Indeed, *American Snuff* – which predates the California UDITPA – is arguably controlling because the Legislature presumably enacted the UDITPA with the understanding that it did not alter existing California law. (See Keesling & Warren, *supra,* 15 UCLA

L.Rev. at pp. 163-164 [the UDITPA distinction between business and nonbusiness income "is in line with . . . existing California practice"].) Moreover, at least one other state court applying the functional test has applied similar reasoning to reach a similar conclusion. (See *American Smelting, supra,* 567 P.2d at p. 907 [holding that rental income from homesites rented to employees constituted business income because the homesites were an integral part of the taxpayer's business operations].)

In light of the reasoning of these decisions, the income from Hoechst's reversion of surplus pension plan assets constitutes business income under the functional test. Hoechst created the income-producing property – the pension plan and trust – in order to retain its current employees and to attract new employees. Hoechst had "broad authority to amend [the] plan" (*Hughes Aircraft, supra,* 525 U.S. at p. 442), and retained an interest in any surplus pension plan assets. It funded the plan with its business income and used these contributions to reduce its tax liability. Hoechst exercised control over the plan and its assets through various committees composed of its officers and employees. For example, Hoechst controlled: (1) the appointment of trustees over the pension plan assets; (2) the appointment of investment fund managers; and (3) the administration of the plan and its assets. In doing so, Hoechst directed the plan's overall investment strategy. Indeed, Hoechst regularly changed trustees and fund managers for various reasons, including inadequate performance, and even "drastically altered" the plan's investment strategy in 1978. The surplus pension plan assets generated from this new investment strategy then allowed Hoechst to reduce or suspend

its contributions to the plan otherwise required under ERISA. (See *Hughes Aircraft, supra,* 525 U.S. at p. 441.) Finally, Hoechst disposed of the pension plan assets by transferring these assets to two new plans and trusts, terminating one of these plans and trusts, and reverting the surplus assets of the terminated plan and trust to itself. Because the pension plan assets contributed materially to Hoechst's production of business income via their effect on Hoechst's labor force, the "acquisition, management and disposition of" these assets "constitute integral parts of" Hoechst's "business operations." (*American Snuff, supra,* [1959-1962 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 201-538, p. 12,053; *Kroehler, supra,* [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-647, p. 14,897-123.)

In reaching this conclusion, we recognize that Hoechst did not own or hold legal title to the pension plan assets, and that ERISA imposed many restrictions on Hoechst's control and use of these assets. (See *Shaw v. Delta Air Lines, Inc.* (1983) 463 U.S. 85, 91.) Nonetheless, Hoechst's control and use of the pension plan assets still contributed materially to its production of business income by improving the efficiency and quality of its workforce which, in turn, generated Hoechst's business income. Thus, the pension plan assets were integral to Hoechst's business operations, because these assets were interwoven into and inseparable from Hoechst's employee retention and recruitment efforts – an essential part of any business operation.

We further note that apportioning income from the reversion to California is equitable in light of the tax

benefits received by Hoechst in connection with its control and use of the pension plan assets. Not only did Hoechst receive an operational benefit from its pension plan contributions, it also received a tax deduction for these contributions throughout the lifetime of the plans. Absent their use in the pension plans, these contributions would have been taxable as business income by California. Thus, Hoechst essentially received the pension plans' contribution to its California business operations *tax free* prior to its reversion of surplus pension plan assets. In fact, absent apportionment of the income from the reversion, Hoechst would receive a windfall because New York – Hoechst's commercial domicile – taxed only a small percentage of the reverted income. Under these circumstances, subjecting income from the reversion to taxation in California is both fair and reasonable.

Finally, the absence of any reference to these pension plan assets in Hoechst's financial statements is irrelevant. These omissions are the product of accounting standards in effect prior to 1985 and do not necessarily reflect the actual relationship between the assets and Hoechst's business operations. In any event, national accounting standards adopted in 1985 now require "expanded disclosures intended to provide more complete and more current information" about pension plan assets in financial statements. (Fin. Acctg. Stds. Bd., Summary of Statement No. 87, Employers' Accounting for Pensions (Dec. 1985) p. 3, at <http://www.rutgers.edu/Accounting/raw/fasb/st/summary/stsum87.htm> [as of May 14, 2001].) The Financial Accounting Standards Board created these standards in an effort to make clearer the link between "pension plan finances" and "the corporations'

operations." (Improving FAS 87 (Oct. 18, 1999) Pensions & Investments, p. 12.) Thus, the failure of Hoechst to report the earnings of its pension plan on its books of account has no bearing here.

We are mindful that the North Carolina Supreme Court reached a contrary conclusion in *Union Carbide, supra,* 526 S.E.2d at page 171. We, however, find the reasoning of the North Carolina Supreme Court questionable in several respects. First, *Union Carbide* seemed to define "integral" as "essential to." (*Ibid.*) As a result, the court applied an overly restrictive interpretation of the functional test. Second, *Union Carbide* appeared to focus on the surplus rather than the income-producing property – the pension plan assets. (*Ibid.*) Thus, the court mistakenly concluded that the pension plan assets did not contribute to the taxpayer's production of business income. Finally, the North Carolina Supreme Court did not consider the California decisions that gave rise to the UDITPA definition of business income even though the court recognized the California roots of the UDITPA. (*Polaroid, supra,* 508 S.E.2d at p. 294.) Because of these deficiencies, we decline to follow *Union Carbide* despite the UDITPA's interest in promoting uniformity. In any event, our reasoning is consistent with the reasoning used by most other jurisdictions that apply the functional test (see *ante,* at p. 31), and conforms to the reasoning used by the Montana Supreme Court in an analogous situation (see *American Smelting, supra,* 567 P.2d at p. 907). Accordingly, we conclude that the reversion created business income under the functional test.

II

Even though Hoechst's reversion of surplus pension plan assets falls within the statutory definition of business income, subjecting the income from the reversion to taxation in California must still pass constitutional muster. Under the federal due process and commerce clauses, "a State may not tax value earned outside its borders." (*ASARCO, supra,* 458 U.S. at p. 315.) The taxpayer bears the " 'burden of showing by "clear and cogent evidence" that [the state tax] results in extraterritorial values being taxed.' " (*Exxon Corp. v. Wisconsin Dept. of Revenue* (1980) 447 U.S. 207, 221, quoting *Butler Brothers v. McColgan* (1942) 315 U.S. 501, 507, in turn quoting *Norfolk & Western R. Co. v. North Carolina ex rel. Maxwell* (1936) 297 U.S. 682, 688.) As explained below, Hoechst does not meet this burden. Therefore, apportionment of the income from the reversion to California is constitutional.

In limiting a state's taxing power, courts "are guided by the basic principle that the State's power to tax an individual's or corporation's activities is justified by the 'protection, opportunities and benefits' the State confers on those activities." (*Allied-Signal, supra,* 504 U.S. at p. 778, quoting *Wisconsin v. J.C. Penney Co.* (1940) 311 U.S. 435, 444.) Thus, there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." (*Miller Bros. Co. v. Maryland* (1954) 347 U.S. 340, 344-345.) Corporate income "earned in the course of activities unrelated to [corporate activities in the taxing] State" is not includible in any apportionment formula. (*Mobil Oil Corp. v. Comr. of Taxes of Vermont* (1980) 445 U.S. 425, 439.) The rationale behind this limitation is self-evident: "In a Union of 50 States, to

permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." (*Allied-Signal, supra,* 504 U.S. at pp. 777-778.)

In construing these constitutional limitations on a state's taxing power, the United States Supreme Court has focused "on the objective characteristics of the [income-producing] asset's use and its relation to the taxpayer and its activities within the taxing State." (*Allied-Signal, supra,* 504 U.S. at p. 785.) This relationship must involve a "flow of value. . . . " (*Container Corp., supra,* 463 U.S. at p. 178, italics omitted.) As such, only income from assets that "serve an operational rather than an investment function" are apportionable to a state for tax purposes. (*Allied-Signal, supra,* 504 U.S. at p. 787.) The mere fact that a transaction has a "business purpose" is not enough. (See *id.* at p. 788.) Although the United States Supreme Court has not clearly differentiated operational and investment functions, it has stated that an asset serves an operational function if it helps the taxpayer "make better use . . . of [its] existing business-related resources." (*Container Corp., supra,* 463 U.S. at p. 178.)

Here, the income-producing asset – the pension plan and trust – undoubtedly served an operational function for Hoechst. Hoechst funded the plan and trust with its apportionable business income. It managed the plan and trust by choosing the trustee and appointing a committee of its officers and employees to oversee the trust's administration, to choose its investment managers, and to guide its overall investment strategy. More importantly, Hoechst created and maintained the plan and trust in order to induce its current employees to stay and to

attract new employees. As such, the pension plan and trust undoubtedly helped Hoechst "make better use" of an important and existing business-related resource – its employees. (*Container Corp., supra,* 463 U.S. at p. 178.) Indeed, Hoechst can hardly claim that the pension plan and trust were separable from its employee recruitment and retention efforts – a crucial part of its business operations in California. Accordingly, subjecting an apportionable share of the reverted pension plan assets to taxation in California does not violate the federal due process or commerce clause.

Disposition

We reverse the judgment of the Court of Appeal and remand for further proceedings consistent with this opinion.

BROWN, J.

WE CONCUR:

GEORGE, C.J.
MOSK, J.
KENNARD, J.
BAXTER, J.
CHIN, J.

DISSENTING OPINION BY WERDEGAR, J.

I respectfully dissent.

The Uniform Division of Income for Tax Purposes Act (Rev. & Tax. Code, § 25120 et seq.) (UDITPA) was intended to help the several states avoid laying conflicting claims on the income of multistate businesses, thereby facilitating compliance with the due process and commerce clauses of the United States Constitution. In today's decision, the court encourages conflicting claims by defining as allocable "business income" (Rev. & Tax. Code, § 25120, subd. (a)) precisely the same type of income that the highest court of a sister state in the only other decision directly on point has defined as nonallocable "nonbusiness income" (*id.*, subd. (d); *Union Carbide Corp. v. Offerman* (N.C. 2000) 526 S.E.2d 167). The court today, in other words, has ensured the UDITPA will not achieve its intended purpose. To what degree the act will fail, only time will tell.

I suspect the act will fail to a large degree, because the majority's definition of business income is potentially all-encompassing. What the majority calls the "transactional test" captures income from transactions and activity in the regular course of the taxpayer's business. The so-called "functional test" addresses income from property. "[I]ncome is business income under the functional test," the majority declares, "if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income." (Maj. opn., *ante, at p. 29.*) The taxpayer's creation and indirect management of the ERISA trust, the majority reasons, "contributed materially to its production of business

income by improving the efficiency and quality of its workforce which, in turn, generated Hoechst's business income." (Maj. opn., *ante*, at p. 34.)

The majority's broad definition of business income under the functional test has two problems, both of which strike at the heart of the UDITPA's purpose of fostering the uniform, constitutional allocation of a single taxpayer's income among the various states entitled to claim a portion thereof.

The first problem is that the majority's definition of business income under the functional test potentially reaches *all* income from business-owned property, thereby rendering illusory, or nearly illusory, the category of nonallocable "nonbusiness" income recognized in the UDITPA. (Rev. & Tax. Code, § 25120, subd. (d).) The majority permits the casual reader to assume that some corporate investments, even after today's far-reaching decision, may not be sufficiently integral to the corporation's business operations for their sale to generate allocable business income. (See maj. opn., *ante*, at pp. 31- 32.) The assumption seems to make the decision less far-reaching and therefore more palatable. But the courts and administrative agencies that wrote the opinions the majority cites for reassurance on this point did not have the benefit of today's decision. After today's decision, income from property is allocable business income if there is "an organic unity between the taxpayer's property and business activities whereby the property contributes materially to the taxpayer's production of business income." (Maj. opn., *ante*, at p. 26.) If this test captures income from an ERISA trust, which a corporation does

not own and in which the corporation has only a contingent, reversionary interest, then the test must also capture income from other investments in property owned by the corporation and expected at some point to produce income available for business activities. Because a corporation must be able to draw upon its assets for business purposes as and when necessary, the wise management of cash and surplus assets to achieve an appropriate balance of liquidity, risk and return is just as essential to the production of business income as the wise management of human resources. We can, therefore, be sure the State Board of Equalization will soon ask itself whether income from the cash management accounts and other investments, wherever located, of corporations doing some business in California is not subject to taxation in California on the same basis as reversionary income from an ERISA trust. While the majority correctly observes that the former type of income has not been taxed by nondomiciliary states as allocable business income in the past (see maj. opn., *ante*, at pp. 31-32), the majority's decision offers no principled basis for predicting that such income will not be taxed as business income in the future.

The second problem is that the majority's definition betrays a narrow, parochial focus on the decisions of our own State Board of Equalization. We cannot safely assume our sister states will share the majority's firm conviction that California law is best. While Californians who participated in drafting the UDITPA may well have been influenced in that exercise by their knowledge of California law (see maj. opn., *ante*, at p. 15), it does not follow that we may properly assume the UDITPA adopted prior California law wholesale, or that we may

treat the pre-UDITPA decisions of a single state's administrative agency as equivalent to authoritative interpretations of a uniform, multistate law. The official comments to the UDITPA do not even mention California law.

That said, I nevertheless agree with the majority that it may be "equitable" (maj. opn., *ante*, at p. 35) for California to tax the reversion to the extent Hoechst Celanese Corporation has deducted its contributions to the pension plan on its prior California tax returns. But equity in this sense is not a concern of the UDITPA. It is, instead, the domain of the tax benefit rule, a judicially developed principle that cancels out an earlier deduction when careful examination shows that a later event is fundamentally inconsistent with the premise on which the deduction was initially based. (*Hillsboro National Bank v. Commissioner* (1983) 460 U.S. 370, 373, 383.)

WERDEGAR, J.

APPENDIX B

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

(Sacramento)

HOECHST CELANESE CORPORATION, Plaintiff and Appellant, v. FRANCHISE TAX BOARD, Defendant and Respondent.	C030702 (Super.Ct.No. 96AS01954) (Filed Dec. 3, 1999)

APPEAL from a judgment of the Superior Court of Sacramento County, William M. Gallagher, Judge. Reversed.

Morrison & Foerster, Eric J. Coffill and Lisa R. Brenner, for Plaintiff and Appellant.

Bill Lockyer, Attorney General, Lawrence K. Keethe, Supervising Deputy Attorney General, and George C. Spanos, Deputy Attorney General, for Defendant and Respondent.

Paull Mines and Anne E. Miller for Multistate Tax Commission, as Amici Curiae on behalf of Defendant and Respondent.

Plaintiff Hoechst Celanese Corporation (hereafter Celanese), a Delaware corporation, seeks refund of $292,142 in corporate franchise taxes plus interest paid

for the year ending December 31, 1985. The trial court denied the refund, finding the apportioned share of a $388 million pension reversion to Celanese from a qualified pension trust constituted business income under the Uniform Division of Income for Tax Purposes Act (UDITPA). (Rev. & Tax Code, § 25120 et seq.)[1]

On appeal, Celanese contends there is no separate, functional test for business income under section 25120, subdivision (a), and, in any event, the pension reversion does not satisfy the functional test, even if it applies. Celanese also argues taxation of the pension reversion is unconstitutional.[2]

We conclude section 25120, subdivision (a) includes both a transactional test and a functional test to determine what constitutes business income for purposes of the UDITPA. In this case, however, the record does not support a determination the pension reversion was business income under either test. We therefore reverse the

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[1] Undesignated statutory references are to the Revenue and Taxation Code.

[2] The Attorney General filed two requests for judicial notice which are unopposed. The March 19, 1999, request, which consists of legislative materials from Internet "home pages" for the Legislature and Governor of New Mexico, is granted. (Evid. Code, § 452, subd. (c).) The August 24, 1999, request, which includes a copy of the slip opinion in *Union Carbide Corporation v. Offerman* (N.C. App. 1999) 513 S.E.2d 341 (hereafter *Union Carbide*), copies of North Carolina procedural statutes and rules regarding the timing of appellate decisions and rights of appeal, and a certified copy of Offerman's notice of appeal in *Union Carbide*, is also granted. (Evid. Code, §§ 451, subd. (f), 452, subds. (a), (c), (d)(2), & (e)(2).)

judgment, and need not address Celanese's constitutional challenge.

DISCUSSION

I

The UDITPA

California employs the unitary business principle and formula apportionment in assessing franchise taxes against corporations like Celanese which do business both inside and outside the state. (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 162-163 [77 L.Ed.2d 545, 551].) The challenge is for states to divide the income subject to tax in an equitable manner.

State corporate tax laws distinguished between income to be specifically allocated and income to be apportioned "[f]rom the beginning." (Peters, *The Distinction Between Business Income and Nonbusiness Income* (1973) So. Cal. Tax Inst. 251, 252 (hereafter Peters).) As a result of efforts by the Council of State Governments and other interested groups, the National Conference of Commissioners on Uniform State Laws and the American Bar Association approved the UDITPA in 1957. (7A, Pt. 1, West's U.Laws Ann. (1999) UDITPA, Hist. Note, p. 356, Prefatory Note, p. 357.) The California Legislature adopted the UDITPA almost verbatim nine years later. (Keesling & Warren, *California's Uniform Division of Income*

for Tax Purposes Act (1967) 15 UCLA L.Rev. 156 (hereafter Keesling & Warren); Stats. 1966, ch. 2, § 7, p. 177.)[3]

The objectives of the UDITPA were twofold: "(1) to promote uniformity in allocation practices among the 38 states which impose taxes on or measured by the income of corporations, and (2) to relieve the pressure for congressional legislation in this field." (Keesling & Warren, *supra,* p. 156.)

The UDITPA treats the corporate taxpayer's income differently depending on its character. "Specifically, 'business income' is [apportioned] among the various states from which the income is derived through a formula based upon the property, sales, and payroll of the taxpayer. [Citations.] '[N]onbusiness income' by contrast, generally is allocated in full to the state in which the taxpayer is domiciled. [Citations.] [¶] Under this statutory scheme, the definitions of 'business' and 'nonbusiness' income are critical." (*Robert Half Internat., Inc. v.*

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[3] Twenty-two other states join California as full members of the Multistate Tax Commission. These states have incorporated the UDITPA into their statutory law. (*Robert Half Internat., Inc. v. Franchise Tax Bd.* (1998) 66 Cal.App.4th 1020, 1023; 62 West's Ann. Rev. & Tax Code (1999 pocket pt.) preceding § 25120, pp. 326-327.) Seventeen additional states are associate members of the Multistate Tax Commission, expressing a commitment to its goals. However, associate members have not adopted the Multistate Tax Compact, which includes the UDITPA. (*Polaroid Corporation v. Offerman* (1998) 349 N.C. 290, 293, fn. 2 [507 S.E.2d 284, 288, fn. 2], cert. den. May 3, 1999, ___ U.S. ___ [119 S.Ct. 1576, 143 L.Ed.2d 671] (hereafter *Polaroid*); §§ 38001, 38006, art. IV.) California adopted the Multistate Tax Compact in 1974. (Stats. 1974, ch. 93, § 3, p. 193.)

Franchise Tax Bd., supra, 66 Cal.App.4th at pp. 1023-1024, fn. omitted.)

In California, section 25120, subdivision (a) defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

"Nonbusiness income" is defined in section 25120, subdivision (d) as "all income other than business income." Nonbusiness income consisting of interest and dividends, or capital gains from the sale of intangible personal property, is allocable to California only if the taxpayer's commercial domicile is in this state. (§§ 25125, subd. (c), 25126.)

II

Factual and Procedural Background

After unsuccessfully pursuing its refund claims through the administrative process, Celanese paid the tax and interest, and filed a complaint for refund in Sacramento County Superior Court. The parties submitted a joint stipulation of facts and numerous exhibits on the first day of the court trial. Celanese called as its only witness Richard S. Payne, who served as a senior tax attorney and corporate officer between 1969 and 1988. The key facts are undisputed.

Celanese manufactures and sells a diversified line of chemicals, fibers, and specialty products. It is a Delaware

corporation, with its principal place of business in New Jersey. In 1985, New York was Celanese's commercial domicile.

The corporation conducts business operations throughout the United States and the world. It has filed franchise tax returns in California since the late 1960's. For purposes of franchise taxes in 1985, Celanese's California apportionment factor was 1.2182 percent, and 1.2182 percent of the total business income of its worldwide unitary business was apportioned to California.

"Celanese created and maintained a qualified defined benefit plan known as the Celanese Retirement Income Plan ('Plan'), which covered both active and retired employees. Celanese also created a tax exempt trust known as the Celanese Retirement Income Plan Trust ('Trust') to receive and invest Celanese's contributions. The [P]lan was a qualified plan under Internal Revenue Code section 401(a), and the Trust was an exempt trust under Internal Revenue Code section 501(a). . . . " Celanese drew its contributions to the Celanese Retirement Income Plan (Plan) from general business earnings. It claimed deductions for those contributions on its federal tax returns and on its California franchise tax returns.

At no time since the first retirement plans originated in 1947 has Celanese shown the assets of the various versions of the Plan or the Celanese Retirement Income Plan Trust (Trust) on its balance sheet. Nor have the earnings from any of the versions of the Trust ever appeared on its books of account.

Celanese maintained the Plan as an inducement to retain its current employees and to attract other qualified

employees. Plan members were entitled to prescribed benefits under the Plan, and no more. Celanese used actuarial gains to reduce its future contributions to the Trust, not to increase benefits. However, at no time prior to the satisfaction of all Plan liabilities could any part of the Trust funds be used for purposes other than the exclusive benefit of the Plan members or their beneficiaries.

Celanese administered the Plan and Trust through its administrative and investment committees. The board of directors appointed committee members from time to time as needed.

The administrative committee administered the paperwork generated by the Plan. Membership included corporate officers and nonofficers.

The investment committee supervised and reviewed the financial operations of the Trust. Membership included Celanese's chief financial officer, controller, and vice president of human resources. The investment committee appointed the investment managers who were assigned the task of achieving the highest possible return on invested capital.

The board of directors received reports on the condition of the Plan and Trust. It had the power to appoint and change the trustee. However, the trustee – not Celanese – held title to the investments in the Trust.

Celanese revised its pension investment strategy at the end of 1978. As a result, the Plan investments exceeded actuarial expectations between December 1978 and December 1982. The gains created a large surplus of

Trust funds. Management urged "it would be more beneficial for [Celanese] and its stockholders to use the cash surplus from [the Plan] for corporate purposes than to leave it in the [P]lan."

The board of directors voted to implement a proposed pension plan reversion. The purpose for seeking termination of the Plan and Trust, and obtaining the reversion, was to avoid surplus in the Plan being used in a takeover bid to acquire Celanese stock.

"Effective January 1, 1984, the Plan and Trust were divided into two plans and two trusts, which generally contained the same Plan and Trust provisions generally described above. The Celanese Retirement Income Plan ('CRIP') covered active employees, and the Celanese Retirement Security Plan ('CRSP') covered retired employees. Both plans were qualified benefit plans under Internal Revenue Code section 401(a).

" . . . Concurrent with the split-up of the Plan, the Trust agreement between Celanese and the Trustee was amended to divide the Trust into two separate trusts: The Celanese Retirement Security Plan Trust ('CRSP Trust') and the Celanese Retirement Income Plan Trust ('CRIP Trust'). Both trusts were exempt under Internal Revenue Code section 501(a). By Resolution of the Celanese's Board of Directors, the assets of the Trust were allocated between the CRIP Trust and the CRSP Trust . . . to ensure that all benefits accrued under the CRIP and the CRSP were as fully funded immediately after the transfer as they were immediately before the transfer, as required by Internal Revenue Code section 414(l)."

Celanese split the Plan into the Celanese Retirement Income Plan Trust (CRIP Trust) and the Celanese Retirement Security Plan Trust (CRSP Trust) to satisfy Internal Revenue Service and Internal Revenue Code requirements. It considered the option of terminating the Plan altogether if the Internal Revenue Service (IRS) and Pension Benefits Guarantee Corporation did not approve the reversion.

The Celanese Retirement Security Plan (CRSP) and the CRSP Trust were terminated after the CRSP Trust purchased annuities for retirees at the cost of $110 million. Once CRSP obtained necessary approvals and satisfied all its obligations, it paid Celanese $388.8 million. The payment represented CRSP Trust assets in excess of liabilities. Celanese used the pension reversion funds to carry out a stock redemption program to reduce the number of outstanding shares.

Celanese properly reported the $388.8 million as miscellaneous income on its 1985 federal tax return. It also reported the pension reversion gain as taxable income on the 1985 tax return for New York, its commercial domicile.

In its statement of decision, the court found that section 25120, subdivision (a) provides for two alternative, independent tests to classify business income: the transactional test and the functional test. The court found the pension reversion represented business income under the functional test, but not the transactional test. Finally, the court found the pension trust served an operational function for Celanese, and taxation of gain on the pension

reversion did not violate the commerce and due process clauses of the United States Constitution.

III

Standard of Review

The taxpayer has the burden of proof in an action for tax refund, and must "affirmatively establish the right to a refund . . . by a preponderance of the evidence." (*Consolidated Accessories Corp. v. Franchise Tax Board* (1984) 161 Cal.App.3d 1036, 1039.) We must accept the trial court's factual findings if they are supported by substantial evidence. (*A.M. Castle & Co. v. Franchise Tax Bd.* (1995) 36 Cal.App.4th 1794, 1801.) However, to the extent the issues in this case involve application of a taxing statute to undisputed facts, we are confronted with questions of law and are not bound by the findings of the trial court. (*Consolidated Accessories Corp. v. Franchise Tax Board, supra,* at p. 1039.)

IV

Tests to Identify "Business Income" Under the UDITPA

As we explained, the UDITPA defines business income as "income arising from transactions and activity *in the regular course* of the taxpayer's trade or business and *includes* income from tangible and intangible property if the acquisition, management, *and* disposition of the property constitute *integral parts* of the taxpayer's regular trade or business operations." (§ 25120, subd. (a), emphasis added.) The pivotal issue in this appeal is what test or tests the Franchise Tax Board (FTB) may use to

identify business income under this statute. No published California appellate decision addresses the question directly.[4]

Celanese contends "there is no separate functional test for business income, and under the plain meaning of section 25120, subdivision (a), business income does not include Celanese's once-in-a-corporate-lifetime pension reversion." (Underscoring in original.) Celanese asserts that "[t]he primary and overriding thrust of the statute is that 'business income' *means* income arising in the regular course of the taxpayer's trade or business. It follows that if income does *not* arise from a transaction and activity in the regular course of the taxpayer's trade or business, it is *not* 'business income.' To be sure, the statute contains, as a specific illustration of the primary definition, the provision that 'business income' *includes* income from tangible and intangible property, when the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. But this illustrative elaboration of the primary definition does *not* enlarge its scope. Indeed, the second clause reinforces the scope of the first clause by providing that income from property is 'business income' *only* when the acquisition, management, and disposition of the property *'constitute integral parts of the taxpayer's trade or business operations.'* " (Emphasis in original.)

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[4] In *Robert Half Internat., Inc. v. Franchise Tax Bd., supra,* 66 Cal.App.4th at page 1024, the parties agreed the definition of business income set forth in section 25120, subdivision (a) contained both a transactional test and a functional test. Thus, the issue was not, in fact, litigated in that case.

The FTB says the functional test for business income is based on the second phrase in section 25120, subdivision (a). According to its argument, the statutory language "applies to income associated with an asset which plays an integral role in the operations of the taxpayer's regular trade or business." The transaction which generates the income need not be a regular or frequent occurrence; an extraordinary event such as the pension reversion qualifies.

Having carefully reviewed the statutory language, the history and purpose of the UDITPA, and interpretation of its uniform provisions by the FTB and sister states, we conclude section 25120, subdivision (a) provides for both a transactional and a functional test. The transactional test focuses on the transaction or activity which gave rise to the gain or loss, and asks whether it occurred in the regular course of the taxpayer's business. The functional test focuses on the character of the property that generated the income, and asks whether that asset was in [sic] integral part of the corporation's regular trade or business operations.

The process of statutory construction begins with an examination of the statutory language. Courts give the words of the statute their ordinary, everyday meaning unless the statute specifically assigns them a special meaning. (*Halbert's Lumber, Inc. v. Lucky Stores, Inc.* (1992) 6 Cal.App.4th 1233, 1238.) "If the meaning is without ambiguity, doubt, or uncertainty, then the language controls." (*Id.* at p. 1239.) If, however, the meaning of the words is not clear, "courts must take the second step and refer to the legislative history." (*Ibid.*)

The fact section 25120 is part of a uniform act administered by a state agency means there are aids to construction in addition to traditional legislative history. Although FTB decisions are not binding on this court, we consider that agency's interpretation of the statute in light of the agency's expertise and technical knowledge, thorough analysis of the issues, and consistency over time. (*Yamaha Corp. v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 7, 10, 14-15.)

We also examine case law from other states which have adopted a similar definition of business income. Indeed, the UDITPA states that " '[t]his act *shall* be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.' (§ 25138.)" (*Times Mirror Co. v. Franchise Tax Bd.* (1980) 102 Cal.App.3d 872, 881, emphasis in original; see, e.g., *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1994) 26 Cal.App.4th 1789, 1794-1796.)

Here, each party insists the meaning of section 25120, subdivision (a) is clear; they disagree whether that plain language gives rise to one or two tests for business income. The disagreement focuses on whether the word "includes" is a word of limitation or a word of enlargement. (See *Muller v. Automobile Club of So. California* (1998) 61 Cal.App.4th 431, 444-445, and *People v. Western Air Lines, Inc.* (1954) 42 Cal.2d 621, 639.)

Other jurisdictions have addressed the same question in recent years, with varying outcomes. "Some state supreme courts read the second clause of the UDITPA as simply modifying the first clause and therefore hold that the definition of business income under UDITPA contains

only the transactional test. [Citations.] However, after these decisions, the legislatures of those states promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income. [Citations.] [¶] Other UDITPA states, however, recognized the second clause as encompassing a second independent test known as the 'functional test.' [Citations.] These states concluded either that the plain language of UDITPA includes the functional test or that the definition of business income is ambiguous, and therefore the respective state supreme courts had the right to construe the statute to include the functional test." (*Polaroid, supra,* 349 N.C. at pp. 295-296 [507 S.E.2d at p. 289].)

We agree with *Polaroid's* analysis of the statutory language, and conclude the plain language of section 25120, subdivision (a) encompasses both the transactional test and the functional test. "[G]rammatically speaking, business income constitutes the subject of the sentence, which is thereafter defined by two independent clauses, each with its own verb and subsequent definitional language. In fact, the statute could grammatically be read as stating: 'Business income means income arising from transactions and activity in the regular course of the corporation's trade or business, and [business income] includes income from tangible and intangible property. . . .' That is, [section 25120, subdivision (a)] does not contain a misplaced modifier, but rather utilizes a compound predicate to illustrate that 'business income' includes the definitions set forth in both the first and second clauses. [Citations.]" (*Polaroid, supra,* 349 N.C. at pp. 297-298 [507 S.E.2d at pp. 290-291]; accord, *Texaco-Cities Serv. Pipeline Co. v. McGaw* (1998) 182 Ill.2d 262 [695

N.E.2d 481]; *Laurel Pipe Line Company v. Bd. of Fin. & Revenue* (1994) 537 Pa. 205 [642 A.2d 472].)

Our reading of the statute is consistent with the history of the UDITPA. Celanese correctly notes the California Legislature did not draft section 25120; it adopted the definition of business income as part of the UDITPA in 1966. Thus, there is little, if any, California legislative history. However, when California adopts a uniform act, the history of the uniform act becomes significant. (See *Abbott Ford, Inc. v. Superior Court* (1987) 43 Cal.3d 858, 894-895 [the fact the Legislature has adopted the words of a uniform act "supports, if not compels" the conclusion it has adopted the purpose and intent of those who drafted that act].)

The UDITPA's definition of business income was patterned after California's long-standing definition of unitary income. (*In re Appeal of Borden, Inc.* (Feb. 3, 1977) [1971-1978 Transfer Binder] Cal. Tax Reports (CCH) ¶ 205-616, p. 14,897-58 (hereafter *Borden*); Peters, *supra*, 1973 So. Cal. Tax Inst. at p. 276; Keesling & Warren, *supra*, 15 UCLA L.Rev. at pp. 163-164.) "The underlying principle in [the earlier Board of Equalization (hereafter SBE)] cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income." (*Borden, supra*, Cal. Tax Reports,

¶ 205-616 at p. 14,897-58; see, e.g., *In re Appeal of Houghton Mifflin Company* (March 28, 1946) 3 Cal. Tax Cases 344, 1946 Cal. Tax LEXIS 16.)[5]

In *Borden*, the Board of Equalization stated that "the continuity between the old and new law suggests that when the Legislature adopted the Uniform Act, it did not anticipate a change in the prior rule that income from assets which are an integral part of the taxpayer's business is subject to apportionment by formula, regardless of whether the income may arise from an occasional or extraordinary transaction." (*Borden, supra*, Cal. Tax Reports, ¶ 205-616 at pp. 14,897-58 – 14,897-59.)

Our reading of section 25120, subdivision (a) accords with the SBE's consistent interpretation of the statute. *Borden* and *In re Appeal of Kroehler Manufacturing Co.* ((Apr. 6, 1977) Cal. Tax Reports (CCH) [1971-1978 Transfer Binder] ¶ 205-646, p. 14,897-123) (hereafter *Kroehler*) interpret the statute to include both a transactional and functional test for business income.

In *Borden*, the SBE considered whether the taxable loss on the sale of goodwill in Borden's liquidation of its California dairy and ice cream operations was " 'business income' to be apportioned by formula among California and other states, . . . or . . . 'nonbusiness income' specifically allocable *in toto* to California," presumably under

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[5] Celanese argues we should not rely on SBE decisions based on definitions which refer to "unitary income" or "unitary business operations" rather than "business income" and "regular trade or business operations." We find no meaningful difference in the accepted usage of these terms. (See Keesling & Warren, *supra*, 15 UCLA L.Rev. at pp. 163-164.)

section 25125, subdivision (a). (*Borden, supra,* Cal. Tax Reports, ¶ 205-616, at p. 14,897-58.) The SBE looked to prior California law and administrative regulations as the basis for its conclusion section 25120 provided for a functional test. (*Borden, supra,* at pp. 14,897-58 – 14,897-59.) It expressly disagreed with the Kansas and New Mexico courts' rejection of the functional test under those states' versions of the UDITPA, noting the rulings were directly contrary to the regulations of the Multistate Tax Commission. (*Id.* at p. 14,897-59.)

Kroehler involved the question whether rebates paid to the furniture company on liquidation of its qualified pension plan constituted business income subject to apportionment for California tax purposes, or nonbusiness income specifically allocable to its out-of-state domicile. (*Kroehler, supra,* Cal. Tax Reports, ¶ 205-649, p. 14,897-122.) The SBE applied *Borden* to conclude the acquisition, maintenance, and disposition of the pension plan constituted integral parts of Kroehler's manufacturing and sales business, thereby satisfying the functional test for business income. (*Id.* at p. 14,897-123.)

The Legislature has not amended the definition of business income since the UDITPA was adopted, strongly suggesting the SBE decisions accord with legislative intent. (See *Coca-Cola Co. v. State Bd. of Equalization* (1945) 25 Cal.2d 918, 922.)

Also persuasive, although not binding, are decisions from other states with similar definitions of business income that have addressed the question now before this court. (*Times Mirror Co. v. Franchise Tax Bd., supra,* 102 Cal.App.3d at p. 881.) The results are mixed, but the

majority of states faced with the issue have concluded the definition of business income encompasses both a transactional and functional test for business income.[6]

V

The Pension Reversion Is Not "Business Income"

Having agreed with the trial court's determination that section 25120, subdivision (a) provides for two tests to determine business income, we now consider whether Celanese's pension reversion constitutes business income under either test.

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[6] Five jurisdictions' judicial decisions hold that the definition of business income includes both a transactional and functional test. (See *Polaroid, supra,* 349 N.C. 290 [507 S.E.2d 284]; *Texaco-Cities Service Pipeline Company v. McGaw, supra,* 182 Ill.2d 262 [695 N.E.2d 481]; *Ross-Araco Corp. v. Bd. of Fin. & Revenue* (1996) 544 Pa. 74 [674 A.2d 691]; *Pledger v. Getty Oil Exploration Co.* (1992) 309 Ark. 257 [831 S.W.2d 121]; *District of Columbia v. Pierce Associates, Inc.* (D.C. App. 1983) 462 A.2d 1129.) In response to court decisions to the contrary, four jurisdictions have amended their statutes to clarify that the functional test exists. (See Iowa: Iowa Code, § 422.32 and *Phillips Petroleum Co. v. Iowa Dept. of Revenue and Finance* (1993) 511 N.W.2d 608; Kansas: K.S.A. § 79-3271, and *In re Chief Industries* (1994) 255 Kan. 640 [875 P.2d 278]; New Mexico: N.M. House Bill No. 349 (amending N.M.S.A. § 7-4-2) approved by Governor, Mar. 18, 1999, http://www.governor.state.nm.us/ (New Mexico) and *McVean & Barlow v. New Mexico Bureau of Revenue* (1975) 88 N.M. 521 [543 P.2d 489]; Tennessee: Tenn.Code, § 67-4-804, and *Federated Stores Realty v. Huddleston* (Tenn. 1992) 852 S.W.2d 206, relying on *General Care Corp. v. Olsen* (Tenn. 1986) 705 S.W.2d 642.)

We explained that the transactional test focuses on the nature of transaction or activity giving rise to the income or loss, and whether it took place in the regular course of the taxpayer's business. Three factors must be considered under the transactional test: "the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income." (*Polaroid, supra,* 349 N.C. at p. 295 [507 S.E.2d at p. 289].)

Here, the reversion of the excess pension funds was the transaction that gave rise to the income, not the operation of the pension plan itself. The record shows Celanese's removal of the surplus funds was an extraordinary – not regular – event, occurring only once in the nearly 20 years Mr. Payne worked for the corporation. As such, the reversion to Celanese did not occur in the "regular course of the taxpayer's trade or business." (§ 25120, subd. (a).) Accordingly, we agree with the trial court's determination the pension reversion was not business income under the transactional test.[7]

Turning to the functional test, the question is whether the gain from the pension reversion arose from " 'tangible [or] intangible property . . . the acquisition, management, and disposition of [which] constitute[d] [an] integral part[ ] of [Celanese's] regular trade or business operations.' " (*Robert Half Internat., Inc. v. Franchise Tax Bd., supra,* 66 Cal.App.4th at p. 1024, quoting § 25120, subd. (a).) We conclude it did not.

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[7] The FTB argues the contrary in response to Celanese's opening brief, but the FTB did not appeal from the trial court's ruling on the transactional test.

Celanese argues that if the functional test exists, "income from tangible and intangible property is business income if the acquisition and management disposition of the property constitute integral parts of the taxpayer's 'regular trade or business operations.' " (Underscoring in original.) The FTB responds that "and" should be interpreted as the disjunctive "or" to carry out "the Legislature's obvious intent as gleaned from the context." We decline the FTB's invitation to disregard the plain language of section 25120, subdivision (a) and the UDITPA. The word "and" ordinarily connotes a conjunctive meaning, while the word "or" implies a disjunctive or alternative meaning. (*Melamed v. City of Long Beach* (1993) 15 Cal.App.4th 70, 79.) Moreover, the FTB's reading is inconsistent with the decision in *Robert Half Internat., Inc. v. Franchise Tax Bd.*, *supra*, 66 Cal.App.4th at pages 1024-1025, where the court focused solely on the *acquisition* of intangible property in finding the loss on repurchase and cancellation of a warrant was not a business loss under the functional test.

The North Carolina Supreme Court provided a more complete analysis of the language of that state's identical statute in *Polaroid*. "First, we note that the phrase 'acquisition, management, and/or disposition' contemplates the indicia of owning corporate property. [Citation.] Moreover, Webster's Dictionary defines 'integral' as meaning 'essential to completeness.' Merriam-Webster's Collegiate Dictionary 607 (10th ed. 1993). Therefore, reading the second clause as a whole, business income includes income obtained from acquiring, managing, and/or disposing of property which is essential to the

corporation's business operations." (349 N.C. at p. 301 [507 S.E.2d at pp. 292-293].)

Here, Celanese did not hold title to the investments in the Trust. Celanese's role was limited to appointing members of the investment committee who, in turn, appointed the fund managers. A trustee held the assets of the Trust, and the individual employees and retirees who participated in the Plan were its beneficiaries. At no time did the assets of the Plan or Trust appear on Celanese balance sheets; nor were the earnings of the Trust reported on the corporation's books of account. Although Celanese used the $388.8 million pension reversion for corporate purposes, that is, in a stock redemption program to reduce the number of outstanding shares, the corporation did not own the asset that generated the gain. We conclude indicia of corporate ownership are simply not present in this record.

There is also no evidence the Plan and Trust were integral to Celanese's business of manufacturing and selling chemicals. The parties acknowledge that Celanese maintained the Plan as an inducement to retain its current employees and to attract other qualified employees. However, the acquisition, management, and disposition of the trust assets were not part of Celanese's regular trade or *business* operations of manufacturing and selling chemicals: Celanese did not hold title to the assets, and in the regular course of its business, the acquisition, management, and disposition of the trust assets did not generate income for Celanese's business, but for the Plan beneficiaries. Thus, they were not part of its business operations. The fact that the termination of the CRSP and

the CRSP Trust resulted in a pension reversion to Celanese did not transform the trust assets into an integral part of its business operations.

Accordingly, we conclude as a matter of law that the $388.8 million pension reversion was not business income for purposes of section 25120, subdivision (a).

DISPOSITION

The judgment is reversed. Celanese shall recover costs on appeal. (CERTIFIED FOR PUBLICATION.)

CALLAHAN, J.

We concur:

SIMS, Acting P.J.

KOLKEY, J.

APPENDIX C

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

(Sacramento)

(Filed Jan. 3, 2000)

HOECHST CELANESE CORPORATION, Plaintiff and Appellant, v. FRANCHISE TAX BOARD, Defendant and Respondent.	(Super.Ct.No. 96AS01954) ORDER MODIFYING OPINION AND DENYING REHEARING [NO CHANGE IN JUDGMENT]

APPEAL from a judgment of the Superior Court of Sacramento County, William M. Gallagher, Judge. Reversed.

Morrison & Foerster, Eric J. Coffill and Lisa R. Brenner, for Plaintiff and Appellant.

Bill Lockyer, Attorney General, Lawrence K. Keethe, Supervising Deputy Attorney General, and George C. Spanos, Deputy Attorney General, for Defendant and Respondent.

Paull Mines and Anne E. Miller for Multistate Tax Commission, as Amici Curiae on behalf of Defendant and Respondent.

THE COURT:

It is ordered that the opinion filed herein on December 3, 1999, be modified in the following particulars:

1. On page 16, footnote 5 is deleted.

2. On page 20, footnote 7 is deleted.

3. On page 21, the first sentence of the first full paragraph is modified, and a portion of the quotation is deleted, so the sentence and quotation now read:

The North Carolina Supreme Court provided a more complete analysis of the language of that state's identical statute in *Polaroid*, noting "that the phrase 'acquisition, management, and/or disposition' contemplates the indicia of owning corporate property. [Citation.]" (349 N.C. at p. 301 [507 S.E.2d at pp. 292-293].)

4. On page 21, at the end of the first full paragraph, the following sentence is inserted after the modified language cited above:

Although California does not *equate* "integral" with "essential" for purposes of determining what constitutes a unitary business (*Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, 413-414), the *Polaroid* analysis properly highlights the closeness of the relationship between the asset and the corporation's business operations required under the functional test for business income.

5. On page 21, at the end of the first full paragraph as modified, a new paragraph is inserted which reads:

The FTB cites the SBE decision in *Kroehler* in support of its argument the Celanese pension reversion is taxable

as business income under the functional test. However, *Kroehler's* factual analysis is brief and conclusory, and the SBE's limited findings distinguish it from the case before us. In *Kroehler*, the taxpayer acquired all the assets of another furniture company, including interest in a pre-ERISA pension plan, to further its business of manufacturing and selling furniture. (*Kroehler, supra,* Cal. Tax Reports, ¶ 205-649, p. 14, 897-123.) It maintained the pension plan to retain and attract employees to perform the required labor. The taxpayer liquidated the pension plan in the course of terminating the entire business operation of its Kentucky subsidiary. The taxpayer, as residuary beneficiary of the pension plan, received the fund surplus as a rebate. (*Ibid.*)

6. On page 22, line 11 of the first full paragraph, the phrase "but for the Plan beneficiaries" is deleted so the sentence reads:

Celanese did not hold title to the assets, and in the regular course of its business, the acquisition, management, and disposition of the trust assets did not generate income for Celanese's business.

There is no change in judgment.

Respondent's petition for rehearing is denied.

FOR THE COURT:

SIMS, Acting P.J.

CALLAHAN, J.

KOLKEY, J.

APPENDIX D

SUPERIOR COURT OF CALIFORNIA
COUNTY OF SACRAMENTO

HOECHST CELANESE CORPORATION

Plaintiff,

v.

FRANCHISE TAX BOARD, An Agency of the State of California,

Defendant.

No. 96AS01954
Dept. 56

STATEMENT OF DECISION

The above entitled matter came on for court trial on May 6, 1997 in Department 56 of the above Court before the Hon. William M. Gallagher, judge presiding. Eric Coffill, Lisa Brenner, Morrison & Foerster appeared on behalf of plaintiff and George Spanos, Deputy Attorney General appeared on behalf of defendant. Further briefing was submitted by the parties after trial and oral argument was held on February 20, 1998 upon which the matter was then taken under submission with plaintiff requesting a statement of decision. The court having considered the parties' objections to the proposed statement of Decision, the court adopts the following as its Statement of Decision:

Evidentiary Objections

Defendant objects to the admissions of Joint Stipulation paragraph numbers 6, 52 and 53 into evidence on the

grounds of relevancy. The Court overrules the objections and deems Joint Stipulation paragraph numbers 6, 52 and 53 admitted into evidence.

Defendant objects to the admissions of Joint Exhibit numbers 26 and 27 into evidence on the grounds of relevance. The Court overrules the objection and deems Joint Exhibit numbers 26 and 27 admitted into evidence.

Taxpayer Action for Refund

Plaintiff Hoechst Celanese Corporation (Celanese) is a corporation organized and existing under the laws of Delaware, with its principal place of business in New Jersey. The commercial domicile of Celanese in 1985 was New York. Defendant California Franchise Tax Board (FTB) is an agency of the State of California and is empowered to assess and collect taxes under the California Bank and Corporation Tax Law, and to make refunds of overpayments of such taxes with interest.

In 1985, after obtaining governmental permission to terminate the Celanese Retirement Security Plan and after satisfying all plan obligations, Celanese received a gain of $388.8 million. Celanese reported the gain as business income in California for franchise tax purposes. On December 6, 1995, Celanese filed a timely Claim for Refund with FTB for 1985. The claim requested that FTB refund the $715,791.35 paid, plus additional interest, on the ground that the pension reversion received by Celanese in 1985 was not taxable by California and because it was "nonbusiness income." Defendant FTB denied Celanese's claim for a refund on the ground that the earnings from the pension reversion constitute "business income."

After payment of all outstanding tax, assessment and interest, Celanese brings this action to secure a refund.

In this action, plaintiff is not seeking to have the entire pension reversion treated as nonbusiness income. The precise amount of the reversion in 1985 was $388,800,000. Using plaintiff's apportionment figure for 1985 of 1.218% and defendant Franchise Tax Board's 1985 tax rate of 9.6% (Rev. & tax [sic] Code § 23151(c)), this generates $454,691 of tax ($388,800,00 [sic] x .012182 x .096). The present action seeks a refund of only $292,142 in taxes paid plus any paid and accrued interest.

This case was tried before the court on the stipulated facts, joint exhibits, defendant's Exhibits A and B, and the oral testimony of plaintiff's witness, Mr. Richard Payne. Jurisdiction and venue for this action is vested in this Court under California Revenue and Taxation Code section 19382 et seq.[1] In a suit for tax refund, the taxpayer has the burden of proof; he must affirmatively establish the right to a refund of the taxes by a preponderance of the evidence. [citations]." (Consolidated Accessories Corp. v. Franchise Tax Board (1984) 161 Cal.App.3d 1036, 1039.) A suit for refund of taxes paid is heard de novo in superior court. (Nast v. State Bd. of Equalization (1996)) 46 Cal.App.4th 343, 348.)

Statement of Facts

The business of Celanese from the inception of its first pension plan in 1947 through the time of the pension

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[1] Unless otherwise specified, all code section references are to the California Revenue and Taxation Code.

reversion in 1985 was manufacturing and selling a diversified line of chemicals, fibers and specialty products. (Joint Stipulation 4.) Since the late 1960s, Celanese has conducted operations in California, as well as other states and countries, and has filed California franchise tax returns. (Ibid.) For 1985, for California franchise tax purposes, Celanese's California apportionment factor was 1.2182% and 1.2182% of the total business income of its worldwide unitary business was apportioned to California. (Jt. Stip. 5.)

Pension Reversion

In 1947, Celanese created and funded, pursuant to applicable federal law, qualified defined benefit pension plans to provide retirement benefits for its employees. (Jt. Stip. 17.) Approximately 29,000 Celanese employees and retirees participated in the pension plan, known as the Celanese Retirement Income Plan and the Celanese Retirement Income Plan Trust, in the early 1980s. (Joint Exhibits 12-15.) Celanese formed the Celanese Retirement Income Plan for the general benefit of its employees and was part of Celanese's compensation package to its employees. (Jt. Stip. 20; Jt. Ex. 29.) Celanese acknowledges a reason it maintained the pension plan was as an inducement to retain its current employees and to attract other qualified employees. (Jt. Stip. 20; Defendant's Ex. A.)

Through the testimony of Mr. Payne, as Vice President and Director of Taxation at Celanese, he stated there was the option to terminate the pension plan if IRS and the Pension Benefits Guarantee Corporation did not

approve the pension reversion. (May 6, 1997, Reporter's Transcript (RT) 74:23-28; 75:14-28; 76:8-28.) Mr. Payne testified that he never heard of any concern expressed that completely terminating the plan was going to cause problems in retaining a qualified and experienced work force. (RT 79:16 to 81:2.)

From the time the pension plan was established, Celanese expressly reserved to itself the right to take back a reversion if circumstances permitted. (Jt. Exs. 2 and 3.) As represented by Celanese, the pension plans in effect from 1947 until 1969 provided that in the event of termination, any excess of funds over what was needed to provide for pensions for employees would revert to the company. (Jt. Ex. 2, p. 23, par. 15.4; p. 22, par. 15.1; Jt. Stip. 27.) This same provision is found in the pension plans in effect from 1969 to 1984. (Jt. Ex. 3, p. 32, par. 14.7; p. 31, par. 14.1; Jt. Stip. 28.)

Celanese administered the pension plan and the trust through its Administrative Committee and Investment Committee. (Jt. Ex. 3, Article 2, p. 7, par. 2.1.) The Board of Directors of Celanese periodically designated people to serve on the two committees. (Ibid.) The Administrative Committee held such powers as were necessary for the proper administration of the plan. Members of the committee were comprised of a corporate officer and non-officers of the corporation. (RT 86:8-20.)

The Investment Committee was responsible for oversight and review of the financial operations of the trust. (Jt. Stip. 45.) The members of the committee included Celanese's chief financial officer, the controller and the vice president of human resources. (RT 47:12-18.) The

committee appointed fund managers who were given the role to take the funds that were contributed and invest it with the goal of achieving the highest return on the invested capital. (RT 47:24-48:1.) The Celanese Retirement Income Plan Trust contained a provision that the investment manager had exclusive authority to manage, acquire and dispose of any assets of the investment account. (RT 50:10-25.) Furthermore, the Board of Directors had the power to appoint and change trustees before and after the Employees Retirement Income Security Act (ERISA) requirements. (RT 87:4-10.) During Mr. Payne's tenure at Celanese, reports were made to the Board of Directors as to the condition of the pension fund. (RT 87:12-15.)

Celanese periodically made contributions to the plan as determined by an independent actuary to satisfy federally mandated minimum funding standards and to provide sufficient funds for the benefit described and promised under the plan. (Jt. Stip. 17.) Celanese's contributions to the plan were made from Celanese's general business earnings. (Jt. Stip. 18.) For all years Celanese filed California franchise tax returns, its contributions to the plan were deducted in full as ordinary and necessary business expenses in computing Celanese's income subject to tax in California. (Jt. Stip. 18 and 26; Def's Ex. A (Admission No. 3); RT 81:7 to 82:25.) Since the late 1960s, Celanese's operations have been conducted in California as well as in a number of other states and countries. (Jt. Stip. 4.) Celanese's contributions to the pension were made to a qualified exempt trust established specifically to fulfill federal requirements. (Jt. Stip. 17; RT 90:8-20.)

At trial, Mr. Payne testified that there was only a remote connection between the contributions which Celanese made to the plan and the value of the plan such that you could not take all of the gains that were realized in any particular year and use those gains to offset your contribution. (RT 97:22 to 98:3.)

Defendant FTB contends that the pension plan actuarial gains were used to reduce future contribution by Celanese to the trust and were not used to increase any benefits under the plan. (Jt. Stip. 21.) If investment gains for the pension fund exceeded actuarial expectations, the amount of Celanese's contributions could be reduced. There was a connection between how the investments in the pension fund did from year to year and the amount of money that was contributed by Celanese to the plan. (RT 88:25 to 89:11; Jt. Ex. 25, p. 8, par. 13.)

To illustrate this point, defendant points to the contributions Celanese made in the pension fund from the year 1977 though 1985. Based on the IRS Form 5500s (Annual Return/Report of Employee Benefit Plan) filed by Celanese, its contributions and the plan's value were as follows for the years indicated below:

Celanese Retirement Income Plan Annual Return/ Report of Employee Benefit Plan

Year	Employer Contribution	CRIP Ending Net Asset
1977	$18,688,632	$218,908,020
1978	$26,902,000	$263,597,081
1979	$35,152,000	$341,672,000
1980	$73,378,000	$497,009,000

1981	$19,614,000	$508,501,000
1982	$ 5,500,000	$616,789,000
1983	0	$697,981,000
1984	$31,450,000	$ 45,916,000
1985	$31,402,000	$ 81,584,000

(See Jt. Exs. 9 through 17, page 4, items 14(a) and 14(q).)

At the end of 1978, Celanese drastically revised its pension investment strategy by introducing new fund managers where each manager was given a specific task in a specific sector in the total financial investment arena. (Jt. Ex. 4.) During the period following this change of investment strategy, the pension plan investments exceeded actuarial expectations and outperformed the "market." (Ibid.)

The actuarial gains which arose during the post 1978 period resulted in a large surplus in the pension fund. (Jt. Ex. 4; Jt. Ex. 28, p. 3; Jt. Ex. 5, p.2.) In September of 1983, Celanese decided that it would be more beneficial for the corporation and its stockholders to use the cash surplus from the pension fund for corporate purposes than to leave it in the plan. (Jt. Ex. 28, p. 4.) The board of directors chose to effect a revision. (Id., at pp. 4-5.) In this regard, it took over two years for Celanese to obtain government approval and to terminate the Celanese Retirement Security Plan. (RT: 58:3-27.)

Mr. Payne testified that Celanese used the pension reversion funds to carry out a stock redemption program which enhanced the value of Celanese Corporation stock

by reducing the number of outstanding shares of stock. (RT 73:5-6; 74:2-12.)

Effective January 1, 1984, the plan and trust were divided into two plans known as the Celanese Retirement Income Plan (CRIP) and Celanese Retirement Security Plan (CRSP) and two trusts known as the Celanese Retirement Income Plan Trust (CRIP Trust) and the Celanese Retirement Security Plan Trust (CRSP Trust). (Jt. Stip. 22 and 23.) During this time period and with the appropriate government approval, Celanese transferred $505,612,000 from the Celanese Retirement Income Plan to the Celanese Retirement Security Plan which had been set up specifically to facilitate the asset reversion plan. (Jt. Exs. 16 and 18.)

In 1984, Celanese also obtained government permission to terminate the CRSP. (Jt. Stip. 25.) These steps resulted, in 1985, in the reversion to Celanese of $388.8 million which represented CRSP Trust assets in excess of liabilities after satisfying all CRSP obligations to its retirees. (Jt. Stips. 22, 23, 24 and 25.) The purpose for obtaining the reversion was to avoid a surplus in the plan from being used in a takeover bid to acquire the corporation's stock. (Jt. Ex. 7.)

Business Income Test – Uniform Division of Income for Tax Purposes Act (UDITPA)

The legal issues presented in this action are whether the $388.8 million pension reversion to Celanese from a qualified pension trust is "business income" as defined

by Revenue and Taxation Code section 25120 for franchise tax purposes and whether taxation of the income reverted to Celanese is constitutional.

FTB contends that the income reverted to Celanese constituted business income under a transactional test and functional test as provided in Revenue and Taxation Code section 25120(a) and thus constitutional. Celanese takes the position that the pension revision [sic] gain should be treated as "nonbusiness income" which means that under California law, the reversion is allocated 100% to Celanese's commercial domicile of New York for 1985. Celanese also contends that even if the pension reversion is taxable under the California statutory scheme (i.e., the reversion is "business income"), such taxation violates the Due Process and Commerce Clauses of the United States Constitution.

In California, a corporations' [sic] state franchise tax base includes income attributable to sources within this state. (Rev. and Tax Code §§ 23151, 23501, 25101.) When a corporation such as Celanese conducts business in more than one state, it is necessary to determine how much of its income is to be attributed to one taxing state as opposed to another. (See Times Mirror Co. v. Franchise Tax Bd. (1980) 102 Cal.App.3d 872, 874; Keesling & Warren, The Unitary Concept in the allocation of Income (1960) 12 Hastings L.J. 42.) To make this determination, California [sic] like 23 other states, enacted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1966 which is set forth in the Revenue and Taxation Code sections 25120 et seq. (See generally, Table of Jurisdictions Wherein Act Has Been Adopted, 62 West's California

Annotated Revenue and Taxation Code (1997 Pocket Supp.) pp. 193-194.)

Section 25120 defines "business income" and "nonbusiness income" as follows:

> "(a) 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
>
> (d) 'Nonbusiness income' means all income other than business income."

FTB argues that the statutory definition of "business income" historically provided for two alternative tests for determining whether income is properly classified as business or nonbusiness income under the so-called transactional test or the functional test.

The transactional test is derived from the first clause of the definition of business income which "means income arising from transactions and activity in the regular course of the taxpayer's trade or business . . . " The functional test is based on the second clause of the statutory definition and "includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Neither party in their Post Trial Brief has cited any published California judicial decision which deals with whether funds reverted from a pension plan are taxable

as business income under section 25120(a). Also, no California judicial decision has been cited to support the existence of both, [sic] a transactional and functional test that is applied to determine whether income is properly classified as business or nonbusiness income.

In FTB's Post Trial Brief, numerous Board of Equalization administrative decisions are cited to support FTB's legal position that a functional test for business income had been in place in California prior to the enactment of the UDITPA. (See Appeal of Borden, Inc. (1977) 22 Cal. Tax Cases 21.) In Board of Equalization administrative decisions that predate UDITPA, there is language in the decisions which state that income from tangible or intangible property was considered business income "if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations. (See cited cases in Appeal of Borden, Inc., supra, at 23.) This quoted language is nearly identical to the second clause of the statutory definition of business income that is currently expressed in section 25120(a).

In 1977, the Board of Equalization applied the functional test to a case involving a pension fund reversion. In the case of In re Kroehler Manufacturing Co. (1977) 22 Cal. Tax Cases 247, 249-250, the Board of Equalization decided that the "acquisition, maintenance, and disposition of the Plan constituted integral parts of appellant's manufacturing and sales business" and accordingly, concluded that the pension reversion funds constituted business income.

FTB also cites the administrative decision of In re Velsico Chemical Corporation (1965) 13 Cal. Tax Cases 252, 254, for the proposition that the manner of disposition of intangibles, whether usual or unusual, is not controlling.

Celanese, in its closing argument and Post Trial and Reply Briefs argue that this Court should not consider any of the administrative decisions cited by FTB as persuasive in establishing a functional test. Celanese is able to cite out-of-state court decisions that have denied the existence of a separate functional test. (See Polaroid Corporation v. Offerman (1998) 496 S.E. 399; Phillips Petroleum Company v. Iowa Dept. of Revenue and Finance (1993) 511 N.W.2d 608; Appeal of Chief Industries, Inc. (1994) 255 Kan. 640, 875 P.2d 278; General Care Corp. v. Olsen (Tenn. 1986) 705 S.W.2d 642.)

Although administrative decisions are regarded as simply administrative opinions and are not binding on this Court they may be cited for their persuasive value, and are occasionally followed in the absence of controlling higher authority. (See McDonnell Douglas v. Franchise Tax Bd. (1994) 26 Cal.App.4th 1789, 1796; 9 Witkin, Calif. Proc. 4th (1997), Appeal, § 922, p. 960.) Courts have also stated that administrative construction of the California tax laws "is entitled to great weight, and the courts generally will not depart from such construction unless it is clearly erroneous or unauthorized." (Container Corp. of America v. Franchise Tax Bd. (1981) 117 Cal.App.3d 988, 1000; Coca Cola Co. v. State Bd. of Equalization (1945) 25 Cal.2d 918, 921; also see Select Base Materials v. Board of Equal. (1959) 51 Cal.2d 640, 647.)

In the present case, this Court finds the discussion and analysis in the administrative decisions of Appeal of Borden, Inc. and Appeal of Kroehler Manufacturing Co. helpful in the construction of section 25120 and presentation of the origin of the functional test which had been applied by California's tax agency prior to the enactment of the UDITPA in 1966.

FTB's Post Trial Brief (PTB) also cite [sic] a number of sister state judicial decisions that have expressly acknowledged the existence of the "functional test" in states which have adopted the UDITPA's definition of business income. These states include Illinois (Kroger Co. v. Department of Revenue (1996) 673 N.E.2d 710); Pennsylvania (Ross-Araco Corp. v. Commonwealth of Pennsylvania (1993) 674 A.2s [sic] 693); District of Columbia (District of Columbia v. Pierce Associates (1983) 462 A.2d 1129); Arkansas (Pledger v. Getty Oil Exploration Co. (1992) 831 S.W.2d 121); and New Mexico (McVean & Barlow, Inc. v. New Mexico Bureau of Revenue (1975) 543 P.2d 489.)

Celanese argues that the out-of-state cases cited by FTB are not persuasive nor well-reasoned and under the facts presented in those cases, the courts did not find in favor of the taxing agency. In support of its position, Celanese has presented out-of-states [sic] cases from North Carolina, Kansas, Iowa and Tennessee which courts have rejected the existence of a functional test.

Decisions of the courts of other states are regarded as persuasive in varying degrees, depending on the point involved. (9 Witkin, Cal. Proc. 4th (1997), Appeal, section 940, p. 980.) They are particularly useful where a similar

statute or uniform act requires construction. (See Fink v. Superior Court (1930) 105 Cal.App. 540, 542; Frazzini v. Cable (1931) 114 Cal.App. 444, 452; Cecil v. Superior Court (1943) 59 Cal.App.2d 793, 798; Sanchez v. Unemp. Ins. App. Bd. (1977) 20 Cal.3d 55, 64.) With the absence of California court decisions, this Court regards the out-of-state court decisions helpful in the statutory construction of the definition of "business income" under the Uniform Division of Income for Tax Purposes Act.

FTB, in its Post Trial Brief, distinguishes the contrary out-of-state court cases cited by Celanese which denied the existence of a functional test for the statutory business income definition adopted under the UDITPA. (FTB PTB 23:11-24:27) FTB points out that subsequent to these adverse court decisions in Tennessee and Iowa, the Tennessee and Iowa legislatures amended their respective codes to make clear that there is a functional test. (See Associated Partnership I, Inc. v. Huddleston (Tennessee 1994) 889 S.W.2d 190, fn.3; Tennessee Code Ann. § 67-4-804(a) (1); Iowa Code § 422.32.) As for Kansas, the legislature amended the definition of business income to allow a corporation the election to have certain income treated as business income as if the functional test applied. (See K.S.A. § 79-3271(a).)

FTB informs the Court that through its research, it has found no appellate court cases that have addressed the issue of whether a pension reversion is taxable as business income. In addition to citing the California administrative decision in Appeal of Kroehler Manufacturing Co. (1977) 22 Cal.Tax Cases 247, FTB also cites foreign administrative decisions which have ruled that pension reversion gains are business income. (See Exxon

Corporation, Petitioner, v. Commonwealth of Pennsylvania, Respondent, 334 Finance & Review 1991, 1991 Pa. Tax LEXIS 1016; Reliance COMM/TEC Corporation, Petitioner v. Commonwealth of Pennsylvania, Respondent, 168 Finance & Review 1995, 1995 Pa. Tax LEXIS 460; and Webster Spring Co., Inc., Petitioner v. Commonwealth of Pennsylvania, Respondent, 625 Finance & Review 1994, 1994 Pa. Tax LEXIS 1884.) Clearly, these foreign administrative decisions carry no weight but are informative as to the application of a transactional and functional test and how a corporation receives the pension reversion gains from the termination of its qualified pension plan which must be treated as income under federal law.

Celanese contends that section 25120(a) creates only a single transactional test to determine whether income of a unitary business is business or nonbusiness income. Under this single test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the "regular course of the taxpayer's trade or business." By Celanese's definition, if income does not arise from a transaction and activity in the regular course of the taxpayer's trade or business, it is not business income. Celanese argues that the second clause only reinforces the scope of the first clause and does not create a "functional test" to classify income.

This argument is similar to the one made in Kroger Co. v. Department of Revenue, supra, 673 N.E.2d at 713-714 where the court explained the existence of the functional test based upon its statutory construction of Illinois' statutory definition of business income which is modeled after the UDITPA. (See Illinois Income Tax Act, par. 15-1501(a) (1).) There, the taxpayer maintained that

the second clause merely clarifies the first clause. The court in Kroger rejected this argument because it found that the plain reading of the second clause expanded the definition of business income. It reasoned that the first clause of section 1501(a) (1) defines business income as arising from "transactions in the regular course of business." The second clause defines business income as income from tangible and intangible property if the disposition of the property constitutes "integral parts of the taxpayer's regular trade or business operations." "[R]egular course of business" is discarded in the second clause. The second clause, then, contains a different definition, not one which simply clarifies.

Revenue and Taxation Code section 25120 is part of the Uniform Division of Income for Tax Purposes Act which was enacted by California in 1966. (Stats. 1966, Ch. 2, section 7.) With regard to construction of the act, Revenue and Taxation Code section 25138 states in part that:

> "This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it."

In keeping with the legislative mandate set forth in section 25138 and based on the above analysis, this Court concludes that the definition of business income under Revenue and Taxation Code section 25120(a) provides for two alternative independent tests to classify business income. These tests are commonly referred to as the transactional test and the functional test. This conclusion provides a definition of business income that is uniform with the states that have enacted the Uniform Division of Income for Tax Purposes Act.

Application of Tests to classify income

To obtain a refund, Celanese has the burden of proof and must show that the pension reversion gains cannot be classified as business income under either the transactional test or functional test.

Under the transactional test, "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. The term "regular" is defined in Webster's Dictionary as "steady or uniform in course, practice, or occurrence" and includes synonyms of the word such as "normal," "typical" and "natural." (Webster's Third New International Dictionary, Unabridged (1986).) Celanese's trade or business is the manufacturing and selling of a diversified line of chemicals, fibers and specialty products. Celanese created and maintained a qualified pension plan for the general benefit of its employees. Given the historical account for terminating the Celanese Retirement Security Plan Trust, it does not appear that the pension fund reversion gain arose from transactions and activity "in the regular course of the taxpayer's trade or business." Giving the usual and ordinary meaning of the term "regular," the reversion was not an occurrence in the normal course of Celanese's trade or business. This Court finds that the pension reversion gain is not "business income" under the transactional test.

Under the functional test, "business income" includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. As demonstrated from the

evidence in this case, a qualified pension plan was established by Celanese for the benefit of its employees as part of its compensation package. The pension plan was maintained as an inducement to retain current employees and to attract new employees. Celanese contends out [sic] that the pension plan was not formed with the intention of later being terminated or reverted. Although title to the investments were held in trust by the trustee of the plan, the plan provided that in the event of a termination, any excess of funds over what was needed to provide for pensions for employees would revert to the company. (Jt. Ex. 3, p. 32, par. 14.7.) The plan also provided that Celanese had the authority to discontinue the plan at any time. (Jt. Ex. 3, p. 31, par. 14.1.) Clearly, the evidence in this case shows that the pension plan was established and acquired by Celanese as an integral part of its regular business operations.

Celanese states that the plan's Administrative Committee met irregularly and spent minimal time administering the plan and the investment decisions were left to outside investment managers and brokers. FTB points to the fact that Celanese's Investment Committee had the authority to appoint and remove investment managers. The Investment Committee also had the power to establish and alter investment guidelines and to adopt and revise pension investment strategies. Reports as to the condition of the pension fund were made to the Celanese Board of Directors. When Celanese drastically revised its pension investment strategy and fund managers, the fund outperformed the "market" with gains in excess of actuarial expectations.

It is clear that Celanese funded the pension plan with annual contributions from business earnings and for all years Celanese filed California franchise tax returns, it claimed deductions on those returns for the contributions it made to the plan. (Jt. Stip. 18.) The amounts of the contributions were determined by independent actuaries employed to calculate the amounts necessary to fund the plan benefits to participating employees.

Celanese disputes this point that there was a connection between how the investments in the pension fund performed from year to year and the amount of money that was contributed by Celanese to the plan. Although Mr. Payne testified that there was only a remote connection between the value of the pension plan and contributions which Celanese made to the plan, it would appear that Celanese's contribution for the years 1981, 1982 and 1983 did decrease as the value of the plan rose dramatically before termination of the Celanese Retirement Security Plan in 1984. (RT:97:22-98:9; RT 88:25-89:11; Jt. Ex. 25, p. 8, par. 13.) From the evidence presented, the Court finds there is a connection between the pension gains and Celanese's contributions to the pension plan. This evidence supports a finding that Celanese provided management to the pension fund as an integral part of its regular business operations.

Celanese makes the final argument that the once-in-a-corporate lifetime pension reversion was not a disposition which constituted an integral part of its regular trade or business operations. It is admitted by Celanese that the primary reason in making the decision to revert the excess amount was to avoid a surplus in the plan that could be used in a takeover bid to acquire Celanese stock.

The reversion was used by Celanese to repurchase shares of its stock thus reducing the number of outstanding shares and increasing the share value. The revision certainly served a specific corporate purpose.

It is of little importance that the reversion was Celanese's first or that it will never happen again for the purpose of applying the functional test since the qualified pension plan was an integral part of Celanese's regular and normal business operations. In this case, the disposition of the pension plan by its termination in accordance with the pension plan terms and ERISA law constituted an integral part of Celanese's regular business operations even if the income was derived from an occasional or extraordinary transaction.

Thus the Court finds that Celanese failed to meet its burden of proof to show that the pension reversion gain did not constitute business income under the functional test. The Court finds that under the functional test, the pension plan constituted an integral part of Celanese's regular business operations. The Court further finds that the pension reversion gain was the result of Celanese's acquisition, management and disposition of the pension plan and pension trust.

The pension reversion gain is defined as business income under the functional test and is properly taxed as business income to Celanese in accordance with the UDITPA. Celanese is therefore not entitled to a tax refund under this action.

Constitutional Challenge

Celanese contends that the taxation of the pension reversion violates the Due Process and Commerce Clauses of the United States Constitution. Celanese argues that case law is clear that unless (1) the payor (Trust) and payee (Celanese) are engaged in a "unitary business," or (2) the capital transaction that produced the income served an "operational" rather than an "investment" function, then FTB cannot tax the pension reversion. (Citing Allied-Signal, Inc. v. Director, New Jersey Division of Taxation (1992) 504 U.S. 768, 119 L.Ed.2d 533.)

In the analysis above, this Court concluded from the facts that the pension plan constituted an integral part of Celanese's business operation. The qualified pension trust clearly served an operational function of Celanese. By no means can the contributions to the pension trust be viewed as an investment for Celanese when the pension was established with the purpose to benefit Celanese employees as part of its compensation package. Celanese's contributions to the pension trust with business earnings was not a capital investment. Celanese periodically made contributions to the plan as determined by an independent actuary to satisfy federally mandated minimum funding standards and to provide sufficient funds for the benefits described and promised under the plan. The contributions were deducted from income as ordinary and necessary business expenses. The fact that title to the pension trust was held in the name of the trustee is a requirement for establishing a qualified pension trust. The fact remains that under the terms of the pension plan, Celanese was entitled to a reversion of the

excess funds in the trust upon termination of the pension plan.

This Court finds that the pension trust was established as an integral part of Celanese's business operations and that the capital transaction to establish the pension plan and trust served as an operational function of Celanese. Therefore, taxation of the reversion does not violate the Due Process and Commerce Clauses of the United States Constitution.

The Court hereby orders that plaintiff take nothing from defendant and that judgment be entered in favor of defendant and against plaintiff in the present action. Counsel for defendant is directed to prepare the judgment.

Dated: Jul 30 1998

/s/ WILLIAM M. GALLAGHER
WILLIAM M. GALLAGHER
Judge of the Superior Court

APPENDIX E

Cal Rev & Tax Code § 25120 (2001)

§ 25120. Definition of terms used in "this act"

As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico,

any territory or possession of the United States, and any foreign country or political subdivision thereof.

Cal Rev & Tax Code § 25138 (2001)

§ 25138. Construction of act; Construction of provisions of Multistate Tax Compact

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it. Enactment of Article IV of the Multistate Tax Compact (as set forth in Section 38006 of the code) pertaining to the allocation and apportionment of income shall be construed as a reenactment of Sections 25120 to 25137, inclusive, without any inference that a change in interpretation is implied by such enactment.

Cal Rev & Tax Code § 25139 (2001)

§ 25139. Citation of act

Sections 25120 to 25139, inclusive, may be cited as the Uniform Division of Income for Tax Purposes Act.